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State of Montana



Report to the Legislature

January 1994

Performance Audit Report

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Regulation and Monitoring of Video Gambling Machines

Department of Justice
Gambling Control Division


This report contains recommendations for improvements to program operations. The recommendations address:

- ▶ Division inspections of video gambling machines.
- ▶ Division enforcement activity.
- ▶ Automated monitoring of video gambling machines.

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Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of four members of the Senate and four members of the House of Representatives.

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January 1994

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The Legislative Audit Committee
of the Montana State Legislature:

We conducted a performance audit of the regulation and monitoring of video gambling machines. This report contains recommendations concerning operations of this program.

We wish to express our appreciation to the Department of Justice and to program staff for their cooperation and assistance.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Scott A. Seacat", written over a horizontal line.
Scott A. Seacat
Legislative Auditor

Office of the Legislative Auditor

Performance Audit

Regulation and Monitoring of Video Gambling Machines

**Department of Justice
Gambling Control Division**

Members of the audit staff involved in this audit were Lisa Blanford, Dave Gould, C. Susan Jensen, Joe Murray, Jim Nelson, and Charles Nemec.

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Elected, Appointed, and Administrative Officials

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Kathy Baertsch, Licensing Supervisor

Jeff Bryson, Investigations Bureau Chief

Ben Kamerzel, Technical Services Supervisor

Report Summary

Introduction

Our performance audit concentrated on the regulation and monitoring of video gambling machines in Montana. The Department of Justice, Gambling Control Division is responsible for regulating most gambling activities in Montana.

Our audit recommends improvements in the division's regulation and monitoring of video gambling machines. Corrective action by the Department of Justice should improve overall effectiveness of regulatory functions. The following sections provide background information and summarize the results of our performance audit.

Background

A video gambling machine is an electronic coin-operated game of chance played on a video screen. There are currently three different types of video gambling machines allowed to operate in the state: keno, draw poker and bingo. Video gambling is the most prevalent form of gambling in the state. During fiscal year 1992-93, the public wagered \$397.5 million on video gambling activities. This accounts for 87 percent of all legal gambling dollars wagered in Montana. Video gambling machine wagers have increased 58 percent since fiscal year 1989-90 when \$251.8 million was wagered. Over 14,500 video gambling machines currently operate in the state. This number has more than doubled during the last six fiscal years.

Montana currently uses a manual system to report and collect taxes levied on video gambling proceeds. Video gambling machine operators and vendors are required to submit this tax on a quarterly basis. Play and income data is collected via meters which are located in each video gambling machine. Tax is then computed on a machine-by-machine basis.

Division monitoring of video gambling machines falls into two main areas: physical inspections of machines, and reviews of gambling machine records including tax returns. We found that these division activities are not an efficient or effective means of regulating and monitoring video gambling machines.

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Division Inspections of Video Gambling Machines

According to division management, division-conducted inspections of gambling machines are a key factor in regulating video gambling. Physical inspections of video gambling machines provide assurance that machine play is fair, the public is protected, and reporting for tax purposes is accurate. We found several areas where division inspections of video gambling machines could be improved.

Investigators Should Conduct More Machine Inspections

During our audit, we reviewed the division's machine inspection records. Only four percent of video gambling machines are inspected each year. The division should establish a centralized management information system for compiling data gathered during gambling machine inspections. This inspection-related management information should be distributed to division staff. In addition, the division should use this system to provide a means of scheduling machine inspections.

Machine Programs not Routinely Tested

The North American Gaming Regulators Association indicates inspections of video gambling machines are to incorporate an analysis of machine operation including testing of each machine's Erasable and Programmable Read-Only Memory (EPROM). An EPROM is a small computer chip inside the video gambling machine containing the program which controls machine operation. During our review, we noted investigators do not thoroughly test video gambling machine operations. Our review found investigators tested the EPROM on only 13 percent of machines they inspected. The division's machine inspections could be improved by developing a formal policy that requires EPROM testing be a standard part of video gambling machine inspections. The division should also develop documented procedures for conducting video gambling machine inspections including EPROM testing.

Gambling Machine Taxation

One of our audit objectives was to determine the effectiveness and efficiency of the process used for collecting tax revenues from video gambling activities in the state. We also evaluated the division's procedures for monitoring these activities. One of the means used to accomplish this was a review of video gambling machine tax returns. Based upon this review we identified the following concerns with the existing system for reporting and collecting tax revenues:

1. Returns are not always properly completed and mathematical errors exist;
2. Documentation of gambling machine income is often missing and inadequate;
3. All machine play is not accounted for;
4. Mechanical and electronic meters repeatedly do not balance;
5. Frequent machine service is apparent; and,
6. Often the correct tax is not paid by gambling establishments.

The system the state uses to report video gambling machine proceeds and taxes is not effective. Our review showed a large portion, 28.7 to 38.4 percent, of gambling establishments pay an incorrect amount of tax on video gambling machine proceeds. An additional 18 to 22 percent of other establishments could be paying an improper tax amount. We found it is difficult to verify machine revenue and taxes paid as the gaming industry does not always provide adequate documentation with video gambling machine tax returns. Our review of video gambling machine tax returns showed that the current tax reporting system does not work as intended.

A number of factors contribute to an improper amount of tax being paid by gambling establishments on the proceeds of video gambling machines. The following sections of the report summary address the causes of problems we found with the tax reporting system and provide recommendations to improve this system. We discuss interim changes which could improve

Report Summary

regulation and the last section recommends a long term solution to the regulation problems inherent with the current system.

Interim Improvements

The current video gambling tax reporting system is not effective or efficient. Our review of tax returns revealed the existing tax reporting system is not effective for ensuring the proper amount of tax is paid on the proceeds of video gambling machines. Our review also revealed the current tax reporting system is not efficient. It is a manual, labor intensive system. It requires an excessive amount of work by both the gambling industry and the division. The reporting system is a time consuming process for gambling establishments. In addition, the division must manually review extensive records as part of its monitoring efforts.

Options for improvement of the current tax reporting system fall into two areas: improvements to the existing manual system and a long-term solution. If the division is going to continue using the current tax reporting system and existing resources, there are some improvements which can be made. Improvements to the existing tax reporting system include:

1. Using penalties and other statutory sanctions to gain better industry compliance.
2. Improving documentation of compliance problems and enforcement status to identify repeat offenders.
3. Expanding the machine service data base to allow additional analysis of service performed on video gambling machines.
4. Increasing staff to provide better regulation.

These changes would improve the tax reporting system; however, the manual system will continue to have inherent problems. The entire system of regulation would be better served by changing to an automated monitoring system.

Long Term Solution

The stand-alone system Montana currently uses is a manual and labor intensive monitoring system. It is not capable of effectively nor efficiently monitoring over 14,500 machines in a state as large as Montana. This is evident by the number of problems we noted with tax returns and video gambling machines during our audit. These problems included: inaccurate tax returns; missing tax return documentation; mechanical and electrical meters not balancing; incomplete tax returns; resetting of meters; and, math errors by establishments and vendors when determining the amount of tax due. We also found video gambling machines operating in the gambling establishments are not always operating according to state specifications. It is just not feasible for division staff to physically inspect all the gambling machines in the state to ensure proper operation.

The more effective and efficient system for monitoring video gambling activities and revenues would be an automated system. One type of automated system which is capable of monitoring video gambling programs as large as Montana's is a dial-up system. This system requires a central computer to "dial out" to gambling machines on a scheduled basis in order to obtain play and revenue statistics. A dial-up system would provide an effective monitoring system with minimal employees. This would also improve the integrity of video gambling by ensuring the public and gambling industry is protected and by enhancing the accountability of public funds. Such a system would be more effective in identifying problems.

It is important to note that a dial-up system monitors the same activities as Montana's current manual system is intended to do. The difference is the dial-up system monitors these activities more thoroughly, efficiently and effectively.

If the current system had increased staffing and improved controls in place, it would be a more effective system and could accomplish things similar to a dial-up system. However, the lack of controls prevent the current system from meeting statutory intent. Automating would provide a system which better meets the intent of Montana's public policy law regarding gambling activities. This is accomplished by providing a level of

Report Summary

monitoring which ensures the public, state and gambling industry are protected from unfair and illegal activities.

The manual monitoring system currently utilized by the department is the cause of most of the problems we found during our review. Therefore, the Department of Justice should implement an automated system. The department should determine what type of data a dial-up system should provide, the most efficient means of operating the system, and how system implementation costs should be recovered. The department will also need to determine how job duties and staffing levels of division employees would be affected. It appears the automated system would not entail an increase in staffing, but instead a change of duties and subsequent training. In addition, the department should determine the time-line for dial-up system implementation. Since implementation of such a system will take time, the department should present its plan to the next regular legislative session.

Chapter I

Introduction

Introduction

The Legislative Audit Committee requested a performance audit of the Department of Justice's Gambling Control Division (GCD). The division is responsible for regulating most gambling activities in Montana under the department's jurisdiction.

Audit Objectives

The objectives of our audit were to:

1. Ascertain the effectiveness of the division's process for inspecting video gambling machines to ensure all machines located in gambling establishments are permitted and meet state specifications.
2. Determine the effectiveness and efficiency of the division's process for collecting and monitoring tax revenues from video gambling activities in the state.
3. Evaluate division activities aimed at protecting state and local jurisdiction revenue derived from video gambling income.
4. Determine if gambling establishments are complying with statutory and administrative rule reporting requirements for video gambling machines.
5. Determine the process other states follow for collecting video gambling tax revenues and monitoring video gambling activities.
6. Determine if improvements are needed in Montana's system of collecting tax revenues and monitoring gambling activities around the state.

Audit Scope and Methodology

Section 23-5-110, MCA, sets forth Montana's public policy pertaining to gambling. The overall intent of this law is to ensure the gambling industry is monitored so the industry is fair and tax revenue is protected. During preliminary audit work, we gathered information on GCD activities to gain an understanding of division operations and to identify areas for review. We interviewed division staff and reviewed records and management information. Based upon this review, we determined the audit should focus on video gambling activities. We

Chapter I

Introduction

also reviewed the amount of time it takes to process applications for gambling operator licenses. We found Montana is comparable to other states. We conducted a performance audit to review controls over video gambling machines and their corresponding revenue. The audit was conducted in accordance with government auditing standards for performance audits.

Audit work was done both centrally (Helena) and in the field. Central audit work included a review of the process used to monitor video gambling revenues, an examination of existing controls over revenues and associated taxes, and identification of monitoring strengths and weaknesses. We compared the process Montana uses to monitor video gambling to standards for regulation recommended by the North American Gaming Regulators Association. In addition, a comparison was done with other states which have video gambling. We also examined the potential for lost revenue due to the current monitoring system.

We selected a random sample of gambling establishments and reviewed their video gambling machine tax returns to determine accuracy of returns and whether the correct amount of tax was paid. Our period of review was the 4th quarter of fiscal year 1991-92 (due to the division by July 15, 1992). We reviewed activity for all machines in the establishments we selected. Our sample was divided into three groups depending on the number of machines in an establishment. This was done to determine if there is a correlation between size of an establishment and accuracy of tax returns and amount of tax paid. Because our sample was a random sample, we were able to project results to the entire population of establishments with video gambling machines, and where applicable, to the population of video gambling machines. In addition, we determined if gambling establishments submitted tax related records as required by statute and administrative rule.

We gathered information regarding how establishments are selected by the division for internal audit. We reviewed the number of desk and field audits completed and the amount of tax and penalty dollars collected as a result of these audits. Auditing techniques and staffing ratios were compared to those used by other states with video gambling. Division staff were

also interviewed regarding policies and procedures for their review of quarterly tax returns.

We conducted unannounced visits to a sample of gambling establishments around the state and physically inspected video gambling machines. This was done to determine if division inventory records for video gambling machines are accurate. We also determined if video gambling machines were appropriately permitted and if machine tampering was evident. These inspections provided a means to determine if gambling machines operating in gambling establishments met state operating specifications required by statute and administrative rule. Meters were tested to verify they were working and to determine if the machines exhibited normal play. We interviewed gambling investigators regarding procedures for inspecting video gambling machines and observed them conducting actual machine inspections.

We explored the need for improvements to the current system utilized by the division to monitor Montana's video gambling activity. We evaluated the feasibility of the division implementing an automated system to monitor video gambling machine activities and to collect video gambling machine taxes. We gathered and reviewed information regarding automated systems and determined the benefits and drawbacks of such systems. We also contacted suppliers of automated systems to obtain information about how such systems can be used to monitor video gambling activities.

We contacted other states which have video gambling programs to determine the kinds of systems they have in place to monitor video gambling activities. We used this information to compare against Montana's system and identify potential alternative approaches to regulation and monitoring of video gambling machines. We also gathered comparative data regarding the types and extent of video gambling available in other states including licensing and tax structure. See Table 7 for this information.

Chapter I

Introduction

Data Limitations

Government auditing standards require the disclosure of any constraints imposed on the audit approach because of data limitations. We were hindered in achieving our audit objectives because of limited documentation supplied by the gambling industry. This situation also hinders the division in its regulation of video gambling machines. Areas where limited data hinders division operations and our review includes:

- Documentation used to verify income and tax due from the proceeds derived from video gambling machines.
- Documentation of service performed on video gambling machines.

These limitations are discussed in detail in Chapter IV.

Compliance

During our audit, we examined compliance with state statutes and administrative rules relating to video gambling machine operations. We found a portion of the gambling industry is not complying with gambling related statutes and administrative rules pertaining to record keeping requirements. This is discussed in detail in Chapter IV.

Management Memorandums

During our audit we issued management memorandums to division officials concerning three less significant issues:

Communication and Coordination - During our review of the division we witnessed many occurrences of inadequate communication, especially pertaining to enforcement activity directed towards gambling operators and vendors. The division should: 1) develop a central and uniform method for recording division-wide regulatory actions; and 2) distribute this information to staff to improve internal communication.

Division Policies and Procedures - The division needs to develop division-wide policies and procedures. Specific policies and procedures would guide division personnel in performing program functions in a consistent and accurate manner. In addition, establishment of procedures strengthens management controls over program operations and provides for improved regulation of the video gambling industry.

Controls Safeguarding Gambling Related Files - The division should adopt a formal policy controlling gambling file access, distribution and tracking. Such a policy would help ensure control over all aspects of gambling record maintenance.

Chapter II

Background

Introduction

This chapter provides information on the history of regulation of video gambling, discusses Montana's current regulatory structure and includes an overview of the Gambling Control Division of the Department of Justice. It addresses the role and responsibilities of the division, organization, funding, and staffing. Information is also provided which describes the extent of video gambling machine activity in this state. This includes information regarding the taxation of video gambling proceeds and distribution of related taxes. The chapter also includes an explanation of how video gambling machine activity and revenue are monitored by the division.

History of Gambling Regulation in Montana

Prior to 1989, most forms of gambling were regulated by local jurisdictions. Statutes at that time segregated the powers and duties related to video gambling regulation between the state and local governments. This segregation led to diverse methods and degrees of control and regulation among the various governing bodies within the state. Of all the legal forms of gambling in the state, state regulators had authority over lottery and horse racing and only limited control in the area of video gambling machines. Regulation and enforcement of video gambling was split between state and local governments. Other legal forms of gambling included live card games, raffles and sports pools.

In 1988, the Montana Gaming Advisory Council of the Department of Commerce recommended the establishment of a central state entity to regulate all forms of gambling in the state. This recommendation was made because of the disparity in regulation and because of the results of an opinion poll of local governments and the general public which supported central control.

Chapter II Background

Gambling Enforcement Centralized

Chapter 642, Laws of 1989, was enacted to "provide uniform statewide regulation of gambling in Montana under the supervision of the Attorney General." The Attorney General created the Gambling Control Division to assume these duties. Video gambling functions from the Department of Commerce and enforcement functions from the Department of Revenue were transferred to the Department of Justice, along with funding and FTE for statewide gambling regulation. The actual change occurred in October of 1989 when the revised gambling laws took effect. Local law enforcement agencies were no longer the primary gambling-related law enforcement organization.

Montana's Legal Gambling

The following table details the current legal forms of gambling.

Table 1	
Current Legal Forms of Gambling	
Video Gambling Machines	Live Card Games
Live Bingo	Live Keno
Raffles	Sports Pools
Sports Tab Games	Calcutta Pools
Casino Nights	Fantasy Sports Leagues
Shake-A-Day	Shaking for Drinks or Music
Fishing Derbies	Wagering on Natural Occurrences
Lottery	Horseracing
Source:	Montana Code Annotated

Gambling Control Division

Gambling Control Division responsibilities include licensing and regulation of all gambling (except Lottery and horse racing). Designated agents of the department are granted peace officer status, with the power of search, seizure and arrest, and the authority to investigate gambling activities in this state. Division staff conduct field inspections and investigations for irregularities in gambling activities. The division licenses all gambling providers and activities. It is also responsible for collecting licensing fees for gambling machines and other gambling

activities and for collection and distribution of taxes assessed on gambling proceeds.

Division Organization

The division is organized into four sections and one bureau: Administration, Licensing, Tax and Audit, Technical Services, and the Investigation Bureau.

Administration includes division management, legal services and state-tribal gaming compact negotiation responsibilities. The section also provides assistance to the Gaming Advisory Council.

Licensing Section processes and issues various gambling licenses and permits. During fiscal year 1992-93, the section issued 1,758 gambling operator licenses, 144 manufacturer's licenses and 428 live card game permits. The section also collects and distributes license and permit fees and maintains files and statistical information.

Tax and Audit Section processes gambling activity tax returns and monitors them to ensure the proper amount of tax is paid. This includes tax examinations on video gambling machines and live game taxes, initiation of tax collections, distribution of tax revenues to local governments and the state General Fund and providing financial reviews necessary for licensing. The section also provides financial examination support for criminal investigations and on-going budget management for the division. This section processed approximately 6,500 tax returns and conducted financial reviews of 766 applicants for licensure during fiscal year 1992-93.

Technical Services responsibilities include compliance testing of prototypes of video gambling machines and machine and program modifications. Division approval must be granted prior to placement of gambling devices in Montana. Staff reviewed 276 machine modifications and tested eight prototype machines during fiscal year 1992-93. Staff also provide technical assistance to investigators, including examination of illegal devices. In addition, the section manages the division's computer system.

Investigations Bureau conducts licensing investigations and regulatory inspections of gambling machines and premises. The bureau also conducts investigation and enforcement activities relative to illegal gambling, with the assistance of local and federal law enforcement agencies. This bureau conducted 2,659 personal background checks required as part of the processing of 766 license applications during fiscal year 1992-93. The bureau

Chapter II Background

also conducted 530 premise inspections and 1,202 gambling related investigations during the same fiscal year.

Division Funding and FTE Levels

Funding for the GCD is derived from a portion of license fees, permit fees, and penalties assessed on gambling activities. The remainder is distributed to local governments. Taxes on gambling-related activities are not used to fund division operations.

Current and historical division expenditures and authorized FTE levels are shown in the following chart:

Table 2			
<u>Gambling Control Division FTE and Expenditures</u>			
Fiscal Years 1990-91 through 1992-93			
<u>Category</u>	<u>Actual FY 1990-91</u>	<u>Actual FY 1991-92</u>	<u>Actual FY 1992-93</u>
Authorized FTE	31.00	36.00	36.00
Personal Services	\$ 955,888	\$1,110,884	\$1,209,576
Operating Expenses	273,286	292,783	311,737
Equipment	54,707	117,345	109,639
Total	<u>\$1,283,881</u>	<u>\$1,521,012</u>	<u>\$1,630,952</u>
Source:	Compiled by the Office of the Legislative Auditor from SBAS records		

The division was authorized 36 FTE for fiscal year 1992-93. There were 21 FTE based in Helena with the remaining 15 FTE based in field offices. The state is divided into three districts to facilitate conducting division responsibilities and functions. District offices are located in Billings, Glasgow and Missoula. There are also staff located in Bozeman, Butte, Great Falls, Kalispell, and Miles City. Field staff consist of investigators and revenue agents. Revenue agents are responsible for conducting reviews of video gambling taxes and related records.

Video Gambling

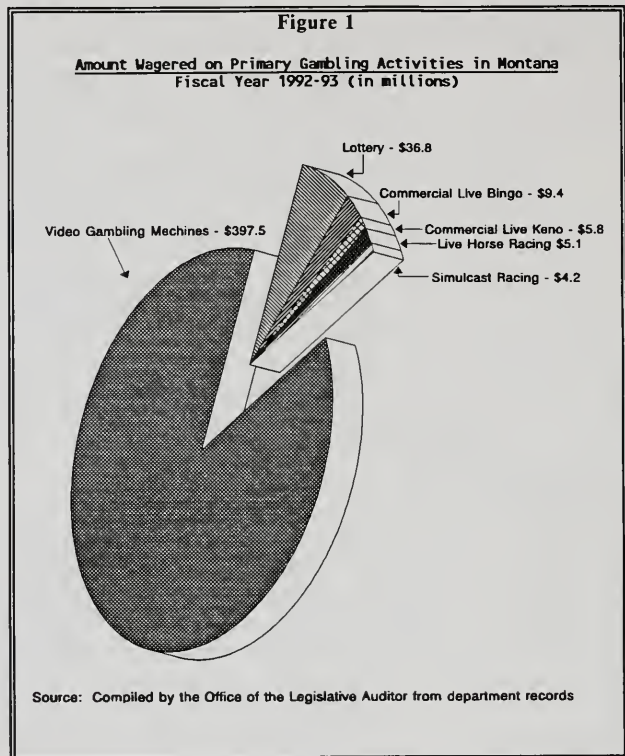
Our audit of the division concentrated on video gambling. The division's monitoring and enforcement of the state's video gambling industry is a major part of its workload.

A video gambling machine is an electronic coin-operated game of chance played on a video screen. There are currently three different types of video gambling machines allowed to operate in the state: keno, draw poker, and bingo. An operator can place up to 20 video gambling machines on a premises. The maximum wager per machine is \$2 with a maximum payout of \$100 on poker and \$800 on keno and bingo. Video gambling machines do not pay out money but instead generate tickets from an internal printer. The ticket is then given to a gambling establishment employee who pays the winner.

Dollars Wagered on Gambling

Video gambling is the most prevalent form of gambling in the state. During fiscal year 1992-93, the public wagered \$397.5 million on video gambling activities. This accounts for 87 percent of all legal gambling dollars wagered in Montana. In contrast, the second largest gambling activity in this state is the Lottery which accounts for approximately 8 percent, or \$36.8 million, of gambling dollars wagered during the same time period. The following figure compares amounts wagered on video gambling to other forms of gambling in the state.

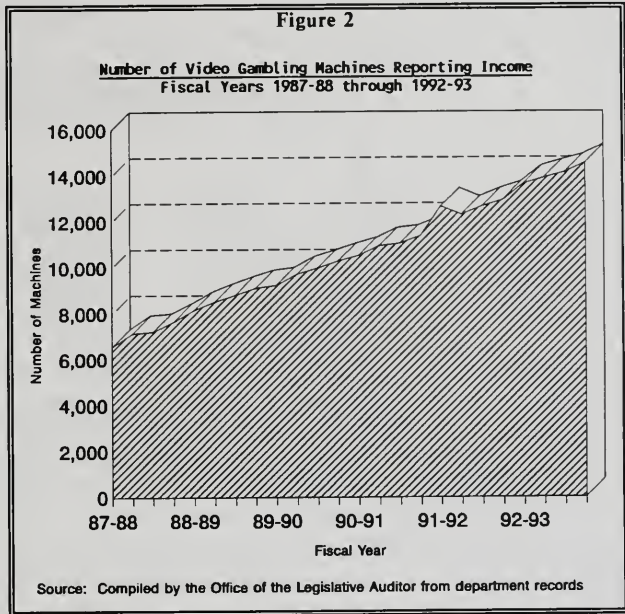
Chapter II Background



Dollars wagered on video gambling have increased by 58 percent since fiscal year 1989-90 when \$251.8 million was wagered on these machines. An increase in the number of video gambling machines is one factor contributing to rising wagers.

Number of Video Gambling Machines

The number of video gambling machines operating in the state has continuously grown over the years. Between fiscal years 1987-88 and 1992-93, the number of machines has increased 121 percent. The following figure shows the number of video gambling machines reporting income for each quarter of the past six fiscal years.



Video gambling machines are either owned by a vendor or by a licensed gambling establishment. Approximately 70 percent of video gambling machines are vendor-owned. Gambling establishments typically receive a portion of the proceeds in return for allowing video gambling machines to be placed on the premises. There are about 1,600 establishments throughout the state which offer video gambling machines.

Gross Income from Video Gambling

Gross income is an important concept of gambling activity and revenues. Gross income represents money put into a video gambling machine less prizes paid out in cash. Gross income is taxed. Video gambling gross income has also increased over the years. Between fiscal years 1987-88 and 1992-93, annual gross income increased 156 percent. The following table shows annual gross income and average gross income per machine.

Chapter II Background

Table 3

Video Gambling Machine Annual Gross Income
and Average Annual Gross Income Per Machine

Fiscal Years 1987-88 through 1992-93

<u>Fiscal Year</u>	<u>Annual Gross Income¹</u>	<u>Average Annual Gross Income Per Machine</u>
1987-88	\$ 70,026,913	\$ 9,161
1988-89	89,943,693	9,889
1989-90	113,363,300	11,040
1990-91	137,044,407	12,032
1991-92	161,732,920	12,502
1992-93	178,926,587	12,752

¹Gross income = gross revenue less prizes paid out.

Source: Compiled by the Office of the Legislative Auditor
from department records

Taxation and Permitting of Video Gambling Machines

Video gambling gross income is taxed. Existing tax structure is 15 percent of the gross income from each video gambling machine per statute. One-third of the tax collected is deposited in the General Fund and the remaining two-thirds is distributed to local governments. During fiscal year 1992-93 total video gambling tax generated was \$26.8 million. The following table shows the increase in quarterly gross income tax revenue for the six most recent fiscal years.

Table 4

Video Gambling Machine Gross Income Tax Revenue
Fiscal Years 1987-88 through 1992-93

<u>Fiscal Year</u>	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>Fiscal Year Total</u>
1987-88	\$2,360,145	\$2,548,145	\$2,656,831	\$2,938,063	\$10,503,184
1988-89	3,136,329	3,309,638	3,401,053	3,644,534	13,491,554
1989-90	3,949,782	4,024,386	4,317,195	4,713,132	17,004,495
1990-91	4,919,102	4,959,603	5,082,883	5,595,073	20,556,661
1991-92	5,866,027	5,906,815	6,180,904	6,306,192	24,259,938
1992-93	6,698,211	6,538,173	6,560,840	7,041,764	26,838,988

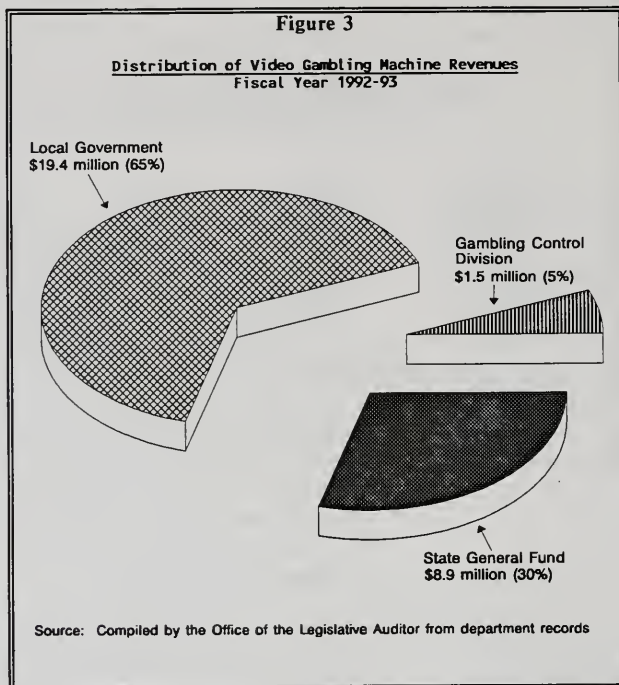
Source: Compiled by the Office of the Legislative Auditor from department records

Operation of video gambling machines also requires an annual permit for each machine. Current cost of the permit is \$200. This fee is prorated on a quarterly basis. The Department of Justice retains 50 percent of the permit fee with the balance returned to the local government jurisdiction in which the gambling machine is located.

**Distribution of Video
Gambling Machine
Related Revenues**

During fiscal year 1992-93, total revenue received from video gambling was \$29.8 million. This was derived from taxes (\$26.8 million) and permit fee revenue (\$3.0 million). Local governments are the primary benefactors of revenue derived from video gambling machines. Approximately \$19.4 million were distributed to local government general funds, \$8.9 million to the state General Fund and the remaining \$1.5 million to the gambling Special Revenue Fund (which funds division activities). This distribution is detailed in the following figure.

Chapter II Background



Division Monitoring of Video Gambling

The following section explains how income derived from video gambling machines is recorded and reported for tax purposes. Division monitoring of video gambling machine activity and revenue is also discussed.

Montana Uses Manual System to Record and Report Income

As previously discussed, proceeds derived from video gambling machines are subject to a tax which is levied on gross income. Montana currently uses a manual system to report and collect this tax. Video gambling machine operators and vendors are required to submit this tax on a quarterly basis.

The first step in submitting required tax on gambling proceeds is determining the amount of play and income each machine receives on a quarter by quarter basis. Play and income data is collected via meters which are located in each video gambling machine. The meters provide the "audit trail" or evidence of earnings for each machine. These meters record the following information:

- | | |
|----------------|---|
| Credits In | - credits placed into a machine, either by coin or paper bill |
| Credits Played | - credits bet during a card hand or game |
| Credits Won | - credits earned after a winning hand or game is played |
| Credits Paid | - credits cashed out by the player |

Each video gambling machine has two sets of meters. One set of meters is mechanical and the other set electronic. The two sets of meters should show the same amounts of play and income. Each set also provides a back up source of data should the other set fail. Although the division reviews both sets of meters, more reliance is placed on the electronic meters.

The second step is determining tax due. Operators or vendors complete a Video Gambling Machine Quarterly Tax Reporting Form which shows play and income information for each machine in a particular establishment. Data readings from each machine's mechanical meters are recorded on this form. Tax is then computed on a machine-by-machine basis for the establishment by the owner of the machine.

In addition to mechanical meter readings supplied on the quarterly tax reporting form, operators or vendors are to submit the printed audit tickets which show the electronic meter readings for each video gambling machine. The following illustration depicts an example of a machine audit ticket and the electronic meter readings.

Chapter II Background

Figure 4

Video Gambling Machine Audit Ticket

SOMEWHERE MT	
SILVERDOLLAR BAR	
Game # 55690018	
A2600C19	
08:47	03/26/93
COINS IN 1	1851
COINS IN 2	3782
CREDIT IN	5633
CR PLAYED	23915
CR AWARDED	21931
GAMES PLYD	10809
GAMES WON	3097
CREDITS PAID	3649

Operators or vendors must also submit reports to the division detailing any service completed on a video gambling machine which may alter any meter readings. These reports are called Video Gambling Machine Service Forms. This form is used to record mechanical and electronic meter readings both before and after machine service is completed. It also is used to record problems which required the service, and action taken to repair the machine. This form is important because it is intended to provide a continuum of machine meter reading data throughout the servicing process.

How the Division Monitors Video Gambling Machine Income

Division monitoring of video gambling machines falls into two main areas: 1) physical inspections of video gambling machines, and 2) reviews of video gambling machine records including tax returns. Division staff perform periodic inspections of video gambling machines. Inspections help ensure machines operating in the establishments meet statutory and administrative rule specifications. These requirements provide assurance that

machine play is fair. Inspections also help provide assurance that reporting for tax purposes is accurate by checking general machine operation. An inspection generally includes an examination of machine serial numbers, machine make and model, and operating permits.

The Tax and Audit Section is responsible for conducting reviews of video gambling machine records. This is done to ensure records are accurate and the proper amount of tax is paid. Monitoring is done primarily during processing of quarterly tax returns. In addition, audits are conducted of gambling establishments. Video gambling machine metering systems provide data indicating machine activity and revenue. Audits assess the reliability of meters and appropriateness of tax paid. We have categorized division monitoring into three different levels: limited, intermediate, and detailed.

Limited Level Monitoring

Limited level monitoring takes place during processing of quarterly video gambling machine tax returns. Two staff manually process approximately 1,600 returns encompassing about 14,000 video gambling machines each quarter. During processing, staff check every quarterly tax return for a number of things. Returns are checked to make sure they are complete and machine audit tickets are attached. Staff verify operator and vendor signatures, liquor and gambling license numbers, and machine serial and permit numbers. They also ensure all machines permitted by the division are included on the tax returns. Mathematical accuracy of returns is checked to assure gross income and tax due calculations are correct. Lastly, staff check to ensure dollars remitted match the calculated tax due.

Intermediate Level Monitoring

Staff conduct audits of some establishments to ensure proper tax is paid. There are two levels of audits: intermediate and detailed. Intermediate level audits, conducted in the Helena office, are referred to as office audits. These audits are limited in nature and use quarterly video gambling machine tax returns and associated documents such as machine audit tickets and service forms. Thus office audits use records provided by gambling vendors and establishments and sent to Helena. Some of the things which may trigger an office audit include:

Chapter II

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- Math errors on a tax return.
- Missing information such as service forms.
- Conversions of gambling machine denomination such as quarter to nickel.
- Past problems with an establishment or vendor.

Detailed Level Monitoring

The more detailed level of monitoring is the field audits which are done by the division's three Revenue Agents. These audits are conducted at selected establishments. The amount of work involved in these audits limits the number the division conducts each year. Establishments are identified for field audit for any number of reasons. More common selection criteria includes lack of or inaccurate data filed with a quarterly tax return and establishments or vendors with repeated problems.

Agents generally review as much as three years' worth of video gambling machine records during a field audit. Records examined include quarterly tax returns, machine audit tickets, mechanical meter records, ticket vouchers, cash records and bank statements. Agents also discuss procedures and controls with establishment owners and machine vendors. In addition to making sure the two sets of meters balance and the correct tax has been paid, agents also examine records for trends and other unique occurrences. Reported meter readings are also compared to other available data such as cash records.

The scope of the division's audits is a key difference between office and field audits. The following table summarizes these differences.

Table 5

Office Audit vs. Field Audit

<u>Area</u>	<u>Office Audit</u>	<u>Field Audit</u>
Span of Records Reviewed	1 quarter	3 years
Type of Records Reviewed	Tax Return Audit Tickets Service Reports	Tax Returns Audit Tickets Service Reports Mechanical Meter Records Ticket Vouchers Business Records Cash Records Banking Records
Areas Reviewed in Addition to Records	None	Business Procedures and Controls Cross-comparison of Records Trend Analysis
Average Time to Complete Audit	3 Hours	2 Weeks
Average Dollars Recovered Per Audit	\$89	\$4,104

Source: Compiled by the Office of the Legislative Auditor

Chapter III - Division Inspections of Video Gambling Machines

Introduction

We reviewed the process the division uses to inspect video gambling machines which are located in licensed gambling establishments throughout the state. These inspections help ensure machines operating in the establishments meet specifications required by state law and administrative rule. These requirements provide assurance that machine play is fair and the public is protected. Inspections also help assure reporting for tax purposes is accurate.

The division's gambling device inspector and twelve investigators complete machine inspections. The gambling device inspector is part of the Technical Services Section. Because investigators visit gambling establishments they also perform inspections of video gambling machines. Investigators are attached to the Investigation Bureau. Machine inspections are one of the investigator's duties.

We conducted field visits to gambling establishments to physically examine video gambling machines. We determined if:

1. Gambling machines came from division authorized manufacturers.
2. Permits and division inventory records for all the machines we examined were accurate and valid.
3. Machines operated properly.
4. Division procedures for conducting inspections ensure video gambling machines meet requirements for machine operation contained in the statutes and administrative rules.

We found that some areas were operating as intended while operations in other areas could be improved. The following sections summarize our observations, including recommendations for improvement.

Chapter III - Division Inspections of Video Gambling Machines

Video Gambling Machines are Supplied by Authorized Manufacturers

Video gambling machines must be manufactured by companies licensed to fabricate gambling machines for operation in this state. In addition, only division tested and approved machine models are allowed to operate in the state. These machines must meet detailed statutory and administrative rule requirements. These requirements are designed to protect the public by controlling the types and numbers of video gambling machines operating in the state. The intent of these provisions is to prevent illegal machines from operating.

Video gambling machines in establishments we visited came from state authorized and licensed manufacturers and are division-tested and approved models. Division procedures are adequate for ensuring video gambling machines which operate in Montana come from authorized manufacturers.

Machines Properly Permitted

Each video gambling machine is required to have an annual permit provided by the division. This permit allows a machine to be legally available for play on an operator's premises. A permit is essentially a license to operate. Machines without a current and valid permit are not legally operable. In order to be eligible for a permit, video gambling machines must be division-approved models and meet statutory and administrative rule requirements governing machine specifications. These specifications incorporate such areas as minimum payout percentages, requirements for printing machine audit tickets, maximum bet and prize limits, game randomness, security of video gambling machines, and metering functions.

The permitting of video gambling machines is important as it helps ensure machines meet statutory and administrative rule specifications which are intended to protect the public and video gambling industry by assuring fair play. In addition, the annual permitting assists the division in tracking video gambling machine location. This information is used to ensure gambling fees and taxes are paid.

We examined video gambling machines for the existence of a fiscal year 1992-93 permit. We compared the machine serial and

Chapter III - Division Inspections of Video Gambling Machines

permit numbers to the gambling operator license to ensure permits were affixed to the correct machines. We also looked for indications of altered machine permits. We found all video gambling machines we examined displayed a current and valid machine permit. In addition, we did not note any evidence of tampering with permits. Our review showed the division has controls in place which assure video gambling machines have current and valid permits. Issues pertaining to division inspections of gambling machines are discussed in the following report sections.

Machine Inventory Records are Accurate

We conducted unannounced visits to gambling establishments around the state. During these visits, we compared video gambling machines found in an establishment against those listed on division records. This was done to determine if division inventory records were correct and whether gambling establishments have properly represented machine inventory to the division. Our comparison was done by verifying video gambling machine serial, model and permit numbers, and game type and make. Our review indicated division gambling machine inventory records are accurate and gambling establishments have correctly represented their inventory to the division.

This examination also allowed us to evaluate controls the division uses to track video gambling machine movement throughout the state. Machine movement is tracked from manufacturer to distributor to gambling operator. Our observations show controls are in place which allow the division to accurately track movement of video gambling machines around the state.

Division Inspections of Gambling Machines Could be Improved

We identified several areas where division inspection of video gambling machines could be improved. These areas relate to investigators conducting more inspections of video gambling machines including testing of machine programs, and management information regarding machine inspections. Since the completion of audit field work the division has changed the duties of the investigators. The following sections discuss these areas.

Chapter III - Division Inspections of Video Gambling Machines

Investigators Should Conduct More Machine Inspections

Division investigators inspect only a limited number of video gambling machines. Only 4 percent of video gambling machines are inspected each year. Division records indicate investigators, on average, inspected only 3.5 machines per month (508 machines total) during fiscal year 1991-92. During fiscal year 1990-91, investigators inspected 4.6 machines per month (665 machines total). Machine inspections completed by investigators decreased by 24 percent during this time period.

According to division management, division-conducted inspections of gambling machines are a key factor in regulating video gambling. These inspections help ensure machines operating in gambling establishments meet specifications required by state law and administrative rule. These requirements provide assurance that machine play is fair and both the public and gambling industry are protected. Inspections also help assure reporting for tax purposes is accurate. Inspections are also important because they have a "deterrent effect" because division staff visit gambling establishments. Inspections also provide the division an opportunity to establish and maintain a rapport with the gambling industry.

Division policy indicates that inspections of gambling machines are a priority of investigators. Performance standards established by the division require each division investigator to test a minimum of ten randomly-selected machines per month. In addition, the division hired a gambling device inspector in the latter part of 1992 to assist investigators in inspecting gambling machines throughout the state.

At the present time, the division has no formal scheduling system for the investigators to follow for completing machine inspections. Investigators stated they informally schedule their own inspections on a low-priority basis as time allows. Investigators indicated they focus their efforts on other duties, such as licensing and criminal investigations. They inspect video gambling machines in response to general public complaints. Very few random machine inspections are conducted.

Chapter III - Division Inspections of Video Gambling Machines

Investigators told us they perform limited machine inspections because they believe operational problems with video gambling machines are rare. However, based upon our review of inspection reports submitted by the division's gambling device inspector, we found 24 percent of machines inspected in video gambling establishments do not operate according to state specifications. These problems could directly affect the amount of tax paid by a video gambling establishment or the fairness of the game. The extent of problems which exist with video gambling machines make inspections an important and necessary regulatory function of the division.

Machine Inspection Information is Needed

Investigators indicated one reason they are unable to formally schedule inspections is because the division is not providing the investigators with the necessary information to do so. During our review, we found the division maintains only limited management information regarding inspections of video gambling machines. Data includes machine serial and model numbers, machine type and manufacturer, and date of inspection. Completed machine inspection forms are kept on file and the division uses a manual system for conducting follow-up. Although machine inspection data is readily available it is not compiled, analyzed, or provided to investigators. Investigators are not aware of the results of machine inspections completed by other division staff.

The lack of machine inspection information has contributed to staff confusion regarding the extent of compliance problems which exist with gambling machines. Some staff believe few problems exist with gambling machines operating according to state statutes and administrative rules. Other staff believe non-compliance is evident. As mentioned previously, division inspection documents show 24 percent of video gambling machines inspected by the division's gambling device inspector have problems of a serious nature including improper meter operation, malfunctions of audit ticket printing features or machines containing unapproved or obsolete program chips (EPROM). These problems could directly affect game fairness. For instance, a machine which operates under the minimum 80 percent payout requirement would result in an unfair minimum rate of return to a player. Improper meter operation

Chapter III - Division Inspections of Video Gambling Machines

could effect the amount of tax paid by a gambling establishment. They could overpay or underpay taxes.

Division Agrees Manage- ment Information is Needed

The division recognizes the importance of a system to provide management and staff with information regarding gambling machine inspections. Division management indicates it plans to compile some information regarding machine inspections.

The division currently has a database where inspection results are input and maintained. Therefore, the division has the foundation for establishing a division-wide information system for machine inspections. The current system needs to be expanded to best meet the division's needs. Division management indicated this system could include information such as: number and type of problems occurring with each machine, whether the same establishments continually have problems, and prevalence of problems in particular areas of the state. Information of this type would provide the division with a tool for better allocating resources.

A centralized system can provide division-wide results of inspections while still providing specific information to each section of the division. For instance, management information could be broken down by staff member to show the number and type of machines inspected per person. Division management could then use this information to determine if employees meet performance standards or to assist in scheduling machine inspections. Such data is also needed to schedule machine inspections. If inspections of video gambling machines are to be a priority, the division must schedule them to ensure they get done. A system for scheduling inspections would provide an organized means to help ensure machine inspections are completed. Such a system would also allow for better coordination of machine inspections for those staff conducting them.

In response to our audit recommendation, division management indicate they are changing the responsibilities of the investigators. All routine gambling machine inspections will now be conducted by the Gambling Device Inspector. Investigators will no longer perform routine inspections. The

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division believes this change will allow them to conduct more thorough and timely inspections of video gambling machines. The division projects each machine will now be inspected once every seven years. They state 1,975 machines should be inspected annually. This projection is based on the premise of zero growth in the amount of new video gambling machines placed in operation. When one considers that approximately 1,600 new video gambling machines were placed into operation during fiscal year 1992-93, it is evident the seven-year inspection cycle would be extended.

Recommendation #1

We recommend the division:

- A. Establish a centralized management information system for compiling data gathered during gambling machine inspections.**
- B. Distribute inspection-related management information to division staff.**
- C. Use this system to provide a means of scheduling machine inspections.**

Machine Programs not Routinely Tested

The North American Gaming Regulators Association indicates inspections of video gambling machines should incorporate an analysis of machine operation including testing of each machine's Erasable and Programmable Read-Only Memory (EPROM). An EPROM is a small computer chip inside the video gambling machine containing the program which controls the operation of the machine. This chip specifies things such as: maximum bet and payout limits, and payout percentages. Testing an EPROM verifies that computer programs for gambling machines are approved versions. This assures machines operate properly, games are fair, and the state and public are protected. Each approved EPROM has a unique signature (code) assigned to it and the division utilizes a signature analysis device to

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determine if EPROMs are an approved version. This testing device verifies the EPROM by reading the signature and indicating whether or not it matches the signature assigned to the chip. Division staff who perform EPROM testing have received applicable training.

During our review, we noted investigators do not thoroughly test video gambling machine operations. We reviewed a sample of completed machine inspections submitted to the division by the investigators. Our review found investigators tested the EPROM on only 13 percent of machines they inspected. In comparison, we found the gambling device inspector tested EPROMs on 86 percent of the machines inspected. We also found that rather than conduct an EPROM test, investigators often compare the program version printed on the gambling machine audit ticket to the approved program version listed in the division's records. However, this is not a reliable test because the computer chip could be programmed to print out the correct program number on the audit ticket but still be an unapproved chip.

Failing to test the EPROM makes it impossible to determine if the program for a video gambling machine is: an approved version, meets minimum payout requirements (probability of winning), and contains games approved to operate in Montana. As a result, problems with video gambling machines may be undetected. In fact, we found 10 percent of the machines inspected by the gambling device inspector had problems related to the EPROM. These problems included EPROM signatures (codes) which were not approved by the division and obsolete machine programs. One of the EPROMS contained a signature which did not match authorized coding. Required coding would have instructed the video gambling machine to maintain a minimum winning percentage of 80 percent.

As a result of minimal EPROM testing, the division may not be meeting all the requirements of section 23-5-110, MCA. This statute requires the division maintain a uniform regulatory climate that assures the gambling industry in the state is fair. According to manufacturers of video gambling machines EPROMs are very vulnerable to manipulation. If the EPROM is taken out of a video gambling machine and re-programmed, one

Chapter III - Division Inspections of Video Gambling Machines

could manipulate the gambling machine to do what one wants. For example, an EPROM could contain coding to allow blackjack to be played on a video gambling machine.

Several investigators told us they did not like testing EPROMs and were uncomfortable doing these tests. While observing investigators conducting inspections of gambling machines, we noticed some investigators were apprehensive conducting EPROM tests. We also observed that testing of an EPROM is a relatively quick process and adds less than five minutes to a machine inspection.

The division has no documented procedures for investigators to reference when conducting machine inspections. Procedures would provide guidance to investigators. For example, investigators said they were concerned about damaging an EPROM chip via static electricity when they touched it. However, other industry documents indicate damaging an EPROM with static electricity can be avoided by touching a conductive material to discharge the electrostatic charges. Procedures developed for the investigators could provide this kind of information.

The division should establish a policy that requires EPROM testing be a standard part of machine inspections. In addition, documented procedures would assist investigators in conducting inspections of video gambling machines including EPROM testing.

Recommendation #2

We recommend the division:

- A. Establish a policy that requires EPROM testing be a standard part of video gambling machine inspections.**
- B. Develop documented procedures for conducting video gambling machine inspections including EPROM testing.**

Chapter IV - Video Gambling Machine Taxation

Introduction

One of our audit objectives was to determine the effectiveness and efficiency of the process used for collecting tax revenues from video gambling activities in the state. We also evaluated the division's procedures for monitoring these activities. One of the means used to accomplish this was a review of video gambling machine tax returns. This chapter presents the findings of our review of quarterly tax returns.

Tax Returns Reviewed

Establishments which have video gambling machines are required to submit a tax return to the division on a quarterly basis. We reviewed these tax returns to determine:

1. If returns were properly completed and mathematical calculations were correct.
2. If returns included all required documentation.
3. If all play was accounted for.
4. If the mechanical and electronic meters for each machine indicated the same amount of play and income.
5. If machine servicing was apparent and the effect it has on verifying amount of income earned and taxes paid.
6. If the correct tax was paid by the gambling establishment based on meter readings and service reports.
7. If the size of gambling establishments influence or affect accuracy of tax returns.

Our reviews were similar to those done by the division during an office audit. The main difference between reviews was in those instances where we lacked documentation in a division video gambling machine tax file to complete our review, we stopped as we were unable to determine if the correct amount of tax was paid by the establishment. Division staff go a step further when they do an office audit and contact the establishments and vendors, often repeatedly, in an attempt to gather the additional documentation and verify amount of tax paid.

Chapter IV - Video Gambling Machine Taxation

Returns Improperly Completed and Mathemat- ical Errors Exist

We estimate between 7.5 and 11.7 percent, or between 120 and 186, of the 1,600 establishments do not fully complete quarterly tax returns. Incomplete returns encompass many things such as: missing or unauthorized signatures; incorrect federal identification or state license numbers; missing mechanical meter readings; and, machine type and credit value not identified. Incomplete quarterly tax returns lead to difficulties verifying income and tax paid and cause additional work for division staff.

We also estimate mathematical calculations on quarterly tax returns are incorrect for 14.7 to 21.2 percent of those establishments submitting a return. These are errors made in converting machine meter readings to tax due. Such errors result in an improper amount of tax being paid.

Documentation of Gam- bling Machine Income is Missing and Inadequate

Video gambling machine operators, as a whole, do not always comply with statutes and administrative rules pertaining to record keeping requirements for gambling licensees. Missing or unreadable machine audit tickets and insufficient documentation provided with quarterly video gambling machine tax returns often prohibited us from determining if the two sets of meters on video gambling machines were in balance and the correct amount of tax was paid. Reporting problems include missing gambling machine audit tickets; missing and incomplete machine service reports; and non-recorded mechanical meter readings.

The extent of required information which is not included with video gambling machine tax returns is a predominant concern identified during our audit. We found video gambling machine audit tickets are either not included with tax returns or are illegible for between 24.5 and 32.3 percent, or between 390 and 516, of the 1,600 gambling establishments. As a result of this and other missing documentation, we were unable to reconcile the two sets of meters (mechanical and electronic) on video gambling machines for 40 percent of the establishments in our sample. We project anywhere from 29.7 to 39.5 percent of the state's gambling establishments with video gambling machines provide insufficient documentation with tax returns to allow for

Chapter IV - Video Gambling Machine Taxation

division reconciliation of mechanical and electronic meters and verification of tax paid.

All Play is not Accounted For

We examined mechanical meter readings for all video gambling machines in our sample to determine if all play was accounted for. This was done by comparing the end of quarter readings to the beginning of the subsequent quarter meter readings. These meter readings should be the same or differences accounted for and documented. If fourth quarter readings were lower than third quarter readings, machine play may be unaccounted for. Based on our review we project 11.5 to 16.9 percent of gambling establishments have video gambling machines in them where all play may not be accounted for. We project these establishments have anywhere from 746 to 861 machines with inconsistent quarterly meter readings. Inconsistent meter readings mean all play cannot be accounted for. This can be the result of machine malfunctions or can be intentional to avoid additional tax liability.

Mechanical and Electronic Meters do not Balance

We examined tax returns and associated documents to determine if the two sets of meters in a gambling machine recorded the same income amounts. We project between 31 and 41.5 percent of gambling establishments have video gambling machines with meters which are out-of-balance. These machines have mechanical and electronic meters which do not record the same amount of play and income occurring on the same machine. We estimate between 1,162 and 1,324 video gambling machines have out-of-balance meters. The following incidents illustrate our observations:

- We found a vendor who had out-of-balance meters on the video gambling machines it owns. A division review of tax returns for the 14 locations serviced by this vendor revealed an additional tax due for a three quarter period of over \$10,000.
- We found another establishment which had video gambling machines with meters which were out-of-balance. Our additional review showed this establishment had discrepancies between mechanical and electronic meters for six of twenty gambling machines.

Chapter IV - Video Gambling Machine Taxation

Ensuring the two sets of meters contained in a video gambling machine balance (record the same amount of play activity) is a key controlling factor in determining accuracy of revenues and taxes paid. One cannot verify income if the two sets of meters do not balance.

Frequent Machine Service is Apparent

We found vendors and gambling establishments perform a lot of service to video gambling machines. Of the establishments we examined, 38 percent performed services to gambling machines during a one quarter period. Mechanical and electronic meter readings commonly change (meters are reset or replaced) during machine servicing. As a result, data which records machine income can be changed during servicing. An excessive amount of service conducted to video gambling machine may indicate a number of things including machine malfunctions or non-reported play. The following examples illustrate our observations.

- We found one establishment which has been continually resetting meters on video gambling machines since 1988. We noted other gambling establishments do the same thing. Many of these machines have the meters reset to zero.
- Another establishment serviced 8 of 19 machines and reset all meters to zero.
- One casino filed 33 service reports during the same quarter. Six of these service reports pertained to one video gambling machine. This may have contributed to this establishment reporting negative gross income for one of its video gambling machines.

Difficult to Determine Effect on Payment of Taxes

Improperly documented machine service makes auditing of tax returns difficult and sometimes impossible. Mechanical and electronic meters provide the record of machine income. If meter readings are changed, the "audit trail" or evidence of earnings for each machine is also changed. In such cases, it becomes hard to verify income and determine the effect on taxes paid.

Correct Tax is not Paid by Gambling Establishments

Our review revealed the amount of video gambling machine tax paid by gambling establishments is incorrect for between 28.7 and 38.4 percent of establishments with video gambling machines. Thus, between 457 and 612 gambling establishments pay the incorrect tax on their video gambling proceeds. When one considers those instances where we were not able to verify the two sets of meters and therefore tax paid, we project between 49 and 60.2 percent (782 and 960) of gambling establishments may pay the incorrect amount of tax on video gambling machine proceeds.

The lack of documentation hindered our determination of dollars of taxes either not paid or paid in error. In those instances where adequate documentation existed, we project anywhere from \$40,091 to \$159,115 total dollars of video gambling taxes were in error during one quarter, April - June 1992. These taxes only represent up to 2.5 percent of total taxes paid in this quarter. However, documentation problems restricted any further estimation of taxes paid in error. These incorrect tax payments consist of both over and under payments of video gambling machine taxes. We found more gambling establishments owe additional tax. We estimate the range of additional tax due each quarter is \$25,145 to \$82,701. Some establishments are also overpaying taxes on video gambling machines. We estimate tax refunds due range from \$14,946 to \$76,414 per quarter.

No Correlation Between Establishment Size and Return Accuracy

During our review of tax returns we found problems occur in all types and sizes of gambling establishments, from small bars and stores to casinos. The number of video gambling machines in an establishment is not an indicator of accuracy of quarterly tax returns. There was some indication that net refunds were due to smaller establishments, while net taxes were due from large establishments. In addition, there is no correlation between erroneous tax returns and machine ownership.

Chapter IV - Video Gambling Machine Taxation

Conclusion - System is not Effective

The system the state uses to report video gambling machine proceeds and taxes is not effective. Our review showed a large portion, 28.7 to 38.4 percent, of gambling establishments pay an incorrect amount of tax on video gambling machine proceeds. An additional 10 to 22 percent of other establishments could be paying an improper tax amount. We found it is difficult to verify machine revenue and taxes paid as the video gambling industry does not always provide adequate documentation with video gambling machine tax returns. Our review of video gambling machine tax returns showed that the current tax reporting system does not work as intended.

The following factors contribute to an improper amount of tax being paid by gambling establishments on the proceeds of video gambling machines. They include:

- Tax returns which are not always accurately completed.
- Mathematical errors in computing income and tax.
- Inadequate and missing documentation of video gambling machine income.
- Unaccounted for machine play.
- Mechanical and electronic meters which do not balance.
- Frequent service of video gambling machines.

The following two chapters address the causes of problems we found with the tax reporting system and provide recommendations to improve this system. Chapter V discusses interim changes which could improve regulation. Chapter VI recommends a long term solution to the regulation problems inherent with the current system.

Chapter V

Interim Improvements

Introduction

This chapter discusses the shortfalls of the existing tax reporting system and presents recommendations for improvement.

Current Video Gambling Tax Reporting System is not Effective or Efficient

According to the North American Gaming Regulators Association, gambling is vulnerable to fraud and abuse because large amounts of cash are involved. Manufacturers of video gambling machines and other gambling devices also state gambling is a high risk area subject to theft and fraud. They further state security and controls are key factors in assuring gambling system integrity. Without careful controls there are a variety of ways to divert or under-report gambling income.

Ineffective Tax System

One of the objectives of our review was to determine the effectiveness and efficiency of the process used for collecting tax revenues from video gambling activities in the state. As noted in the previous chapter the existing tax reporting system is not effective for ensuring the proper amount of tax is paid on the proceeds of video gambling machines.

System is Labor Intensive

Our review also revealed the current tax reporting system is not efficient. It is a manual labor intensive system. It requires an excessive amount of work by both the gambling industry and the Gambling Control Division.

Extensive Paperwork Required

The current system requires extensive paperwork. The gambling industry must maintain machine operation records for a period of three years. Some of the required records include:

- Machine audit tickets which must be printed every 7 days.
- Printed ticket vouchers.
- Weekly readings of each machine's mechanical meters.
- Documentation of the cash count by machine which must be done every 7 days.

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Reporting System is Time-Consuming

In addition to other required records, gambling establishments must submit tax returns to the division on a quarterly basis. Completion of tax returns is a time consuming process. Mechanical meter readings from all gambling machines in an establishment are recorded on the tax return. Documentation of electronic meter readings must also accompany the return. Records of any service conducted on a video gambling machine is to be submitted.

Division Must Manually Review Extensive Records

Most of the records which statutes and administrative rules require gambling establishments and vendors to maintain are provided to the Gambling Control Division. Data is submitted for each of the over 14,500 video gambling machines which operate in the state. This data is submitted on a quarterly basis. The division uses this information as a primary means of monitoring gambling industry compliance with gambling statutes and administrative rules.

Two division staff members manually process quarterly tax returns. This includes reviewing those records submitted with tax returns. Staff spend about three months processing tax returns and related documents submitted during each quarterly reporting period. By the time processing is complete, returns for the next month are being submitted to the division. The current system does not leave these division staff with much time to conduct actual monitoring activities. Only 1.5 percent of gambling establishments receive a detailed level of review by division staff each year.

The extensive paperwork, and the time consuming and labor intensive nature of the manual system cause the current tax reporting system to be inefficient.

Deficiencies Exist with Regulatory Activities

Under the current system, key regulatory activities include: 1) physical inspections of video gambling machines, and 2) detailed reviews of video gambling machine records. These safeguards help provide for a uniform regulatory climate and assure that gambling is fair. During our audit we identified deficiencies with both these activities. The current manual system makes regulation of the gambling industry difficult.

Interim and Long-Term Improvements Needed

Options for improvement of the current tax reporting system fall into two areas: improvements to the existing manual system and a long-term solution. If the division is going to continue using the current tax reporting system and existing resources, there are some improvements which can be made. Improvements to the existing tax reporting system include:

1. Using penalties and other statutory sanctions to gain better industry compliance.
2. Improving documentation of compliance problems and enforcement status to identify repeat offenders.
3. Expanding the machine service data base to allow additional analysis of service performed on video gambling machines.
4. Increasing staff to provide better regulation.

These changes would improve the tax reporting system; however, the manual system will continue to have inherent problems.

The following sections of this chapter discuss interim improvements to the tax reporting system. A long term solution is discussed in the following chapter.

Monitoring Compliance and Enforcing Gambling Regulations

Improvements can be made with division monitoring of industry compliance with tax reporting and record keeping regulations. The following section addresses areas where the division could perform additional monitoring related to the taxation of video gambling.

Use of Penalties and Sanctions

Statutes provide for the department to prescribe record keeping requirements for gambling licensees. Statutes also state a licensed operator shall keep a record of the gross income from each machine in such form as the department may require. The Administrative Rules contain detailed record keeping and record retention requirements for video gambling machines. These provisions are necessary to ensure game play is fair and the public, gambling industry and state are protected. Records

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provide the primary means of monitoring gambling activities and revenue. It is the statutory duty of the department to administer provisions of the Gambling Act.

We Identified Industry Noncompliance

During the course of our review of the division, we found the video gambling industry is not complying with statutes and administrative rules pertaining to record keeping requirements for gambling licensees. Based on our review of quarterly video gambling machine tax returns, we project between 29.7 and 39.5 percent of the state's gambling establishments do not provide required records with tax returns. We also found video gambling machine audit tickets are missing or unreadable for between 24.5 percent and 32.3 percent of all establishments with video gambling. Insufficient documentation provided with quarterly video gambling machine tax returns precluded us from determining if the two sets of meters on video gambling machines were in balance for 40 percent of our sample of establishments. Therefore, we were unable to determine if the correct amount of tax was paid by these establishments. These compliance problems were discussed in detail in chapter IV.

Division is Aware of Industry Noncompliance

The division also has identified industry noncompliance with record keeping provisions. GCD issued over 2,800 noncompliance letters to video gambling machine vendors and operators from January 1, 1992 to January 1, 1993. Currently, there are over 1,600 vendors and gambling establishments operating in the state. Reporting problems identified by the division include missing video gambling machine audit tickets; missing and incomplete machine service reports; mechanical and electronic meters which have been reset, scrambled, and zeroed; nonrecorded mechanical meter readings; and frequent servicing of video gambling machines.

Records of machine play and revenue are the only reasonable means of determining tax due. In an effort to verify revenue and tax information on tax returns, division staff must contact each establishment or vendor which did not supply required records. This process involves a great deal of work on the part of the division. Often times, operators must be contacted repeatedly. This results in a backlog of work and also causes increased administrative costs to the division. Tax returns are

"held-up" awaiting resolution of compliance problems. This also results in delays in collecting additional revenues due the state.

The division can assess a record keeping penalty. The division's policy is to penalize the operator in the amount of \$250 or 1/2 of the assessed tax due, whichever is greater. Division policy states,

"Those who do not keep adequate records should be penalized. The review of required records is the only reasonably efficient method the division has to determine whether or not the proper amount of tax has been paid. Those who violate record keeping statutes and rules should be provided with sufficient incentive to correct their practices."

**Existing Record Penalty
not having Effect**

A review of division records revealed record keeping penalties were assessed about 45 times since 1987. Even though some establishments are assessed a record keeping penalty these penalties are usually waived once the establishment complies with record keeping provisions and provides requested documentation. Given the extent of compliance problems which are prevalent with video gambling vendors and operators not providing required video gambling machine play and income records, it appears the existing penalty policy has not had much of a positive effect.

Discussions with division management and staff indicate the department has opted to use "passive" enforcement procedures. In fact, division policy states, the record keeping penalty " . . . is not expected to be imposed frequently. . . ." The department relies on verbal contact and notices of violation to attempt to bring facilities into compliance with statutes and administrative rules. Video gambling vendors and operators are allowed many opportunities to correct identified problems. Penalties are seldom invoked and department suspension or revocation of a gambling operator's license has not occurred as a result of noncompliance with record keeping requirements.

Gambling industry representatives themselves state there should be a threat of punitive action or penalties. They further state, as long as this does not exist some gambling operators and vendors will "push to see what they can get away with." Strong

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enforcement of existing laws is the key to preventing abuses, according to a representative of gambling device manufacturers.

Section 23-5-136, MCA, provides the department with injunction and other remedies regarding violation of gambling provisions. Remedies include provisions for civil and criminal penalties, and authority to deny, suspend or revoke a license for noncompliance. Statutes also allow for a licensee to be placed on probation. In addition, this section contains enforcement provisions which provide for cease and desist orders and injunctive relief. It appears the division should actively regulate to obtain improved industry compliance with record keeping and record retention provisions.

Recommendation #3

We recommend the division actively regulate through increased use of penalties and other statutory sanctions to ensure improved industry compliance with recordkeeping and record retention provisions.

Tracking Industry Non-compliance

Under the current manual tax reporting system, identifying problem areas to determine cause and develop solutions to compliance problems is not easy. During our review we found the division's historical data pertaining to penalty assessment and noncompliance by establishments and vendors is not readily available or easily analyzed.

Penalty-Related Data not Compiled

In seeking data from the division pertaining to assessment of penalties (arising from processing of tax returns and office audits) against gambling vendors and establishments, we found the division does not collect or analyze this data. Division staff would have to review individual files for 1,600 gambling establishments to determine which had been assessed penalties, date penalties were assessed, penalty amounts, and whether compliance was obtained.

**Current Compliance
Tracking Method not
Efficient**

We also found the division does not have an efficient system for reviewing and analyzing compliance-related documents which are sent to gambling vendors and establishments. Any existing analysis is done by relying on staff memory to identify problematic operators and vendors. If a case history needs to be developed, staff manually review records pertaining to a particular operator or vendor. These records can be extensive and include correspondence, licensing information, quarterly tax returns, machine service reports, violation notices, and telephone logs. Due to the amount of records involved in reviewing case history, this process is time consuming.

Information pertaining to gambling industry compliance problems and division enforcement action could be used to identify repeat offenders. For example, the division could identify those establishments and vendors which repeatedly receive notices of violation. The division could then better justify invoking penalties or taking other administrative action to promote timely compliance by problem video gambling establishments. This information could also be used to identify trends in compliance and enforcement concerns such as metering problems specific to certain brands of video gambling machines.

During our review of gambling files, we found numerous examples of continued noncompliance by gambling vendors and operators. For example, one tavern has continually zeroed the meters on video gambling machines over a six month period. The operator did not submit machine service forms, which document alterations done to meters, as required by the division. We found other establishments which have repeatedly not provided all required mechanical meter readings on the Quarterly Tax Reporting Form. We also noted many establishments which have reset or zeroed meters on video gambling machines for years and did not provide supporting documentation. This problem dates back to 1988 for one establishment.

Management indicates they rely on manual tracking of compliance problems and enforcement activities. They further state staff currently do not have time to manually compile case histories on all operators and vendors for compliance activities each quarter.

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Currently, there are only two staff which monitor industry compliance with record-reporting requirements and enforcement actions taken by the division. There are 1,600 gambling establishments in the state. Given the extent of continued compliance problems we found during our review, it is evident the current system is not an adequate means of monitoring industry compliance. The division should expand the current "tracking" system (manual or automated) to better document gambling industry compliance and enforcement status.

Basic data from compliance letters is currently placed on the division's computer system. Data is grouped by type of compliance problem such as unauthorized signature on a tax return or missing audit machine tickets. This could be expanded to include recording of the noncomplying vendors or establishments, tracking of compliance status, identification of repeat offenders, and maintenance of historical data.

In addition, the division could develop a status log which could be placed in each gambling establishment's tax file. Division staff could use this log to note compliance activities pursued by the division. For example, staff could record information regarding notices of violation or data pertaining to assessment of penalties. Staff would then have a quick means of reviewing an establishment's case history without spending time to review the contents of an entire file. Implementation of this recommendation will help to support the use of penalties particularly for repeat offenders. It would also allow for more efficient use of staff resources.

Recommendation #4

We recommend the division implement a system to document video gambling compliance problems and division enforcement status.

**Monitoring Machine
Service Reports**

Each time service or repair is performed on a video gambling machine, a machine service form must be submitted to the division. This form details problems which occurred and repairs performed, and identifies the machine and who performed the repairs. As previously discussed, we found the gambling industry does not always submit machine service reports as required by administrative rule. We also found that although the division collects those service reports submitted by vendors and establishments, the division is not thoroughly using these reports.

Some data from machine service reports is already input on the division's computer system. The data includes machine serial number, date of service, failure/problem code, service repair code, and who performed the service. The system's database lists all service reports input pertaining to a particular machine. It is a complete history of reported machine service. The database also contains information pertaining to manufacturer, model and permit numbers and operator license number. The division currently only uses data on the system to determine if a service report has been submitted for a particular machine. This system could be expanded to provide information which highlights machine service which appears to be unusual, excessive or does not fit other parameters of standard machine service and repair. Division staff could analyze machine service information and use it to select vendors and gambling establishments for a more detailed review by division staff. However, in those instances when vendors or establishments conduct machine service and do not submit a service form, the division will still be unable to monitor machine service.

The more often a gambling machine is serviced or repaired the greater the risk the improper amount of tax has been paid. This is because history of machine activity can be erased, changed or manipulated. Therefore, compiling and analyzing information pertaining to machine service is vital. This type of data could be used to identify areas that require division attention. For example, analysis could consider the number of service reports filed by a particular vendor or establishment, or on a particular machine, and use this information to "flag" vendors and establishments for audit review. These reports could also be

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used to identify machine denomination conversions so division staff could examine tax returns to make sure the proper amount of tax is levied against these machines. It could also be used to identify particular types or brands of machines which have greater incidence of malfunctioning.

As previously mentioned, there is frequent servicing conducted on video gambling machines. For example, one casino filed 33 machine service reports in one quarter, six on one machine alone. We also found another establishment where 50 percent of the machines in that establishment were serviced and meters were zeroed. Another establishment serviced 19 of its 20 video gambling machines during the same quarter. Further examination during our review revealed the two sets of meters on each of these machines indicated different amounts of revenue. This concern is not limited to casinos only. We also noted many smaller gambling establishments which had a large amount of service performed on video gambling machines. Machine service can result in undisclosed play and an improper amount of tax being paid.

The division should expand the machine service report database to help identify compliance problems with reporting requirements and select operators and vendors for detailed compliance reviews.

Recommendation #5

We recommend the division expand the machine service report database to identify compliance problems and to select operators and vendors for detailed compliance reviews.

Staffing

The current tax system used to record and report video gambling machine activity and revenue is a manual system. This system involves extensive paperwork, and the time consuming and labor intensive nature of the manual system cause inefficiencies with the current tax reporting system. If the division wants to ensure a high level of reliability with the tax reporting system, division staff have to conduct field audits and more inspections of video gambling machines. This can only be accomplished with increased staff. Existing staffing levels limit the level of review which can be accomplished by the division.

**Office-based Audits are
not an Effective Means of
Monitoring**

Because of the volume of gambling machines in the state, the division's current monitoring system concentrates on attempting to address obvious problems with reporting of video gambling machine revenue and tax assessment. One of the primary monitoring functions the division relies upon to address reporting problems is division conducted office-based audits. These are reviews of quarterly tax returns and accompanying documents. Up to 20 percent of establishments are reviewed by office audit during a quarter. However, these audits are not thorough nor the best means of monitoring video gambling revenue. Although office audits provide some assurance that returns are accurate and correct taxes are paid, the lack of documentation and the nature of the tax reporting system result in a high risk of error as indicated by our review of tax returns. Under the current reporting system as many as 60 percent of gambling establishments may be paying the incorrect amount of tax.

**National Standards
Recommend On-site
Audits**

According to the North American Gambling Regulators Association, reported revenue can better be confirmed through on-site audits and then only to the extent that the video gambling machine being reviewed was fully functional and operated without interruption. The division completes some on-site or field audits. The Tax and Audit Section is responsible for conducting these audits. Only 1.5 percent of establishments are audited each year. At this rate it will take the division over 65 years to conduct a field audit at each gambling establishment in

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the state. When one considers the rate at which the number of video gambling machines operating in the state is increasing (15 percent increase during fiscal year 1991-92) the cycle for completing field audits is much longer. Increased numbers of machines result in increased workload for division staff. Montana's video gambling establishments cannot currently be examined in the timely manner which is achieved by other states.

Montana's Monitoring not Comparable to Other States

In reviewing the monitoring activity of other states, we attempted to locate a state with a tax reporting system similar to that used in Montana. We found Nevada is the only other state which uses a non-automated system to record and monitor video gambling machine activity. Video gambling machines in Nevada are not linked to a central state-run computer. Nevada relies on field audits and inspections of video gambling machines to ensure proper reporting of income and tax payment.

Nevada Gambling Estab- lishments Audited Every Three Years

In order to provide assurance that gambling machines exhibit fair play and establishments report all revenue and pay the proper amount of tax, Nevada conducts a tax audit of each gambling establishment in the state once every three years. All of Nevada's audit related work is conducted in the field. In contrast to Montana, office-based audits are not used as a means of monitoring.

Montana's Gambling Es- tablishments Audited Every 65 Years

Given current staffing levels, if every Montana gambling establishment were to receive a field-based tax audit we project it would take the division 65 years to audit all establishments. If the Gambling Control Division were to increase its monitoring efforts to achieve a level of review similar to Nevada, additional staff would be needed. We project a three year field audit cycle would require a minimum of 21 additional FTE. Such a cycle would also correspond with Montana's three year record retention requirement for gambling establishments. The following table provides comparative information regarding Montana and Nevada's audit functions.

Table 6

Comparison of Audit Resources

	<u>Nevada</u>	<u>Montana</u>
Number of Gambling Establishments Offering Video Gambling	2,000	1,615
Number of Audit Section Staff	107	7
Ratio of Audit Staff To Establishments	1:19	1:231
Field Audit Cycle (years)	3	65

Source: Compiled by the Office of the Legislative Auditor

**Gambling Machines should
be Inspected More Often**

Nevada's other key control is regular inspections of video gambling machines. Nevada inspects all video gambling machines once every five years. We found other states inspect video gambling machines more often than that. Louisiana inspects each machine once every three years. On the other extreme is the state of Oregon which inspects each machine six times per year. In order to achieve a level of monitoring similar to that used by other states, additional inspections of Montana's video gambling machines are needed. Division staff estimate with the current rate of inspection, it will take a minimum of seven years to inspect each video gambling machine in the state. An addition of two staff for machine inspections would allow Montana to inspect each gambling machine once every three years.

**Additional Staff are
Needed in Montana**

An increase in division staffing of 23 FTE would provide a level of monitoring comparable to that achieved by Nevada which also has a non-automated system. Continued increases in the number of gambling establishments and video gambling machines operating in the state may necessitate additional staffing increases.

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Costs of FTE Increases as Should Revenue

We calculated the cost of this increase in staffing. We estimate the costs of a 23 FTE increase in the first year would be approximately \$1.2 million. This includes operating and equipment expenditures that would be required by these staff as extensive travel would be required of these positions. On-going cost (personal service and operating expenses) of this staff increase would be a minimum of \$929,000 per year. The 23 positions would consist of 21 revenue agents and two gambling device inspectors.

The 21 revenue agents would have several monitoring responsibilities. The time devoted to field audit could return an additional \$1,033,000 per year. This assumes each agent would conduct 12 field audits per year and recover approximately \$4,100 per audit, as was recovered in fiscal years 1990-91 and 1991-92.

Conclusion

Although additional staff would improve the level of monitoring conducted by the division, problems would continue to exist because of the nature of a manual reporting system. Since this system relies on the gambling industry providing the division with required documents there would still be problems with unreadable machine tickets, missing documentation, reset meters and excessive machine service. With a manual system, on-site auditing and other time consuming monitoring efforts would still be necessary to verify the accuracy of video gambling information including taxes paid. Although increased staffing would have a deterrent effect, it is not a solution to the problems encountered with the current tax reporting system. A current field audit had to be cancelled because the establishment did not have any records.

The entire system of regulation would be better served by changing to an automated monitoring system. The following chapter discusses the aspects of an automated solution to the current system problems.

Chapter VI

Long Term Solution

Introduction

In the previous chapters we provided recommendations for improving division regulation. However, these changes only address some of the symptoms of the problems. Long-term solutions are needed. This chapter discusses an overall solution to the problems we identified during our audit.

These problems included: inaccurate and incomplete tax returns; missing documentation with tax returns; mechanical and electrical meters not balancing; resetting of meters; and, math errors made by establishments and vendors when determining the amount of tax due. These problems often result in an incorrect amount of tax being paid on video gambling machine proceeds or an inability to determine the proper tax. Under the current system as much as 60 percent, or 960 of 1,600 gambling establishments may pay an incorrect amount of tax. We also found video gambling machines are not always operating according to state specifications. For example, 10 percent of the gambling machines inspected by staff have problems related to the program chip.

Montana Needs to Automate Monitoring of Video Gambling Machines

By adopting a public policy law regarding gambling activities in the state, the Montana Legislature intended to ensure a suitable gambling environment exists. Section 23-5-110, MCA, proclaims the legislature's intent that Montana maintain a uniform regulatory climate assuring the gambling industry is fair. This includes protecting the public from unscrupulous operators and illegal gambling activities depriving state and local governments of tax revenues. Our review shows that Montana does not currently have an environment which assures proper monitoring, uniform regulation, and a fair video gambling industry.

The manual, decentralized, stand-alone, monitoring system is not conducive to effective regulation of video gambling activities. The most likely long-term solution to establishing an effective monitoring system would be to change from a manual system to an automated monitoring system.

An automated monitoring system would be the most efficient and effective system for regulating Montana's video gambling activities. Automated systems offer greater security because more information is provided to regulators on an ongoing basis. Such a system would allow continual monitoring of video gambling activities and would identify concerns such as financial discrepancies, operating failures or attempted video gambling machine tampering through the central control site. Other states and provinces which have implemented video gambling or video lottery utilize such an automated system with success. A central computer system requires fewer employees, less paperwork, decreases the risk of lost revenue through skimming or other control problems and maximizes revenue through efficient and timely collection of funds.

The North American Gaming Regulators Association (NAGRA) is an organization comprised of gambling regulators which identify gambling regulation concerns and develop procedures to address these problems. NAGRA has developed standards related to video gambling and made recommendations to improve the regulation of video gambling activities. One of the standards adopted by NAGRA is for video gambling activities and revenues to be monitored by an automated system. Gambling device manufacturers concur with these standards. NAGRA recommends automated monitoring for the following reasons:

- Frequent gathering of data.
- Timely information.
- Data entry of gambling machine information is fully automated.
- Risk of human calculation error reduced.
- Complete reporting of all video gambling machine activities and revenues.
- Regulator achieves complete control over video gambling machines.
- Tight security over video gambling machines.
- Timely and efficient collection of tax revenues.

Two Kinds of Automated Systems

Two types of automated systems are available which are capable of monitoring video gambling programs as large as Montana's: an on-line system or a dial-up system. Both systems provide essentially the same type of monitoring capability and the same kind of information. The main difference is an on-line system communicates continuously with video gambling machines 24 hours per day, seven days a week. A dial-up system requires a central computer to "dial out" to gambling machines on a scheduled basis in order to obtain play and revenue statistics.

We considered the benefits of both the on-line and dial-up systems. Both systems provide high levels of security and monitoring capabilities. However, the majority of other video gambling states monitor gambling activities utilizing a dial-up system. This is because the dial-up system offers effective monitoring capabilities while costing less than an on-line system. Consequently, we considered a dial-up system the most practical system to examine.

Other States Use Automated Monitoring Systems

We contacted other states with video gambling programs. All but one state have automated systems to monitor video gambling activities and revenue. Several states using automated monitoring systems told us they reviewed Montana's video gambling program before implementing their video gambling programs. They thought Montana would be a good source of information since Montana was one of the first jurisdictions to regulate this kind of gambling. Although they duplicated general gambling requirements, they elected not to duplicate Montana's manual monitoring system. The other states did not believe a manual system provided a sufficient level of security and control over video gambling activities. Because Montana was one of the first states or provinces to regulate video gambling, its monitoring system lacks the sophistication and initial capital outlay found in states with automated systems.

Some of the other states which have video gambling machines include: Louisiana, Oregon, Maryland, Minnesota, South Dakota, West Virginia and Wisconsin. In addition, many Canadian Provinces also have video gambling machines. These states and

provinces all use automated systems to monitor video gambling. Two of the states contacted (South Dakota and Louisiana) utilize a dial-up system while other states such as Oregon utilize an on-line system. Both systems provide similar information to regulators. This information includes the number of games played, games won, dollars wagered, dollars paid out, machine malfunction data, and machine servicing.

The states using automated monitoring systems indicated these systems are very efficient and effective for monitoring video gambling activities and revenue. For example, during fiscal year 1991-92 South Dakota monitored 6,666 video gambling machines statewide in 1,363 gambling establishments. Officials in South Dakota told us they are able to effectively monitor the activities and revenues of each machine on a daily basis with 12 FTE.

The only state we contacted which does not use an automated monitoring system is Nevada. However, in addition to its other staff, Nevada has approximately 107 audit-related staff who audit every gambling establishment once every three years. Nevada is considering implementing a dial-up system to monitor establishments which provide video gambling only. Nevada gambling officials indicate the intent of such a change is to maintain an economic and effective monitoring level without hiring additional staff.

The following table compares basic gambling regulation and tax statistics for various states.

Table 7

Comparison of Video Gambling Among Various States

	<u>Montana</u>	<u>Louisiana</u>	<u>Nevada</u>	<u>Oregon</u>	<u>S. Dakota</u>
Number of Video Gaming Establishments	1,600	2,500	2,000	1,125	1,360 ¹
Number of Video Gambling Machines	14,000	9,000	150,000	5,165	6,670 ¹
Gross Revenue Tax Rate	15%	22.5%	3-6.25%	65%	35%
Annual Permit Fee Per Machine	\$200	\$1,000	\$250	\$100	\$100
Max. Number of Video Gambling Machines Per Establishment	20	3 ²	15 ³	5	10
Type of Tax Reporting System	Manual	Dial-up	Manual	On-line	Dial-up

¹ Does not include Deadwood, S.D.

² Truckstops can have up to 50 video gambling machines

³ Only applies to "restricted" type gambling establishments, nonrestricted (casino) establishments have no limits

Source: Compiled by the Office of the Legislative Auditor

Montana Lottery utilizes an Automated Monitoring System

When lotto games were first established in 1989, the Montana Lottery implemented an automated monitoring system. During fiscal year 1992-93 a total of \$27.7 million was wagered on the Montana Lottery's on-line games (Powerball and Montana Cash). This compares to \$397.5 million wagered on video gambling machines during this same period. There are 330 retailers which offer lotto games versus over 1,600 establishments which have video gambling machines.

Montana Lottery uses an automated monitoring system. The Lottery's system monitors the on-line lottery games in order to maintain the integrity of its games. This system monitors, stores and compiles ticket sales information. Information includes the date and time tickets are purchased, revenue collected, location at which tickets are purchased and the numbers a player selects to wager on.

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Long Term Solution

Components of a Dial-up System

A dial-up system is an automated monitoring system designed to provide centralized information of video gambling activity including play statistics and revenue data. This is accomplished by a central computer system communicating with video gambling machines throughout the state. It provides daily monitoring and full accountability of video gambling activity and revenue which is not possible with a stand-alone system.

Dial-up systems are generally comprised of seven basic components: management terminals; a central computer; dedicated computer/phone lines; remote polling sites; telephone lines; and the video gambling machines themselves.

Management Terminal - This is a personal computer used by computer operators to communicate with and obtain information from the video gambling machines located around the state.

Central Computer - The central computer stores and processes the data for the entire system. It stores information gathered from each video gambling machine connected to the dial-up system.

Dedicated Computer/Phone Lines - These lines allow communication between the remote polling sites and the central computer. They are dedicated specifically for communication between the remote polling sites and central computer.

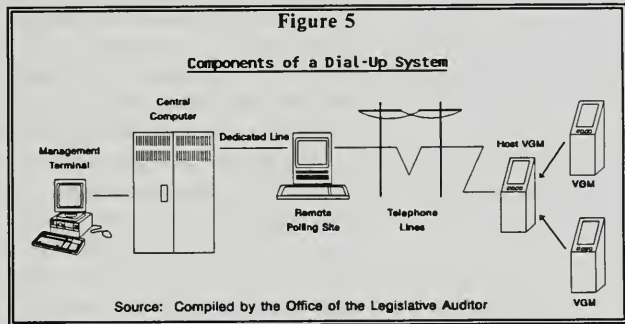
Remote Polling Site (RPS) - An RPS is a personal computer which directs communications between the video gambling machines and the central computer. A RPS streamlines the communications between video gambling machines and the central system because one RPS can gather and transfer information from several establishments. It eliminates the need of running communication lines from every video gambling machine to the central computer.

Telephone Lines - Telephone lines provide communication between the establishment and the RPS. They could be an existing telephone line used by the gambling establishment or a dedicated line used only for the dial-up system.

Host Video Gambling Machine - This video gambling machine is located in gambling establishments and facilitates communication between other video gambling machines in the establishment and the RPS.

Video Gambling Machines (VGM) - These are the actual video gambling machines. On most automated systems video gambling machines will not operate unless they are connected to the dial-up system. This provides the regulating agency complete control over gambling machine activities.

The following figure illustrates how these components are linked together in a dial-up format.



Dial-up System Could Streamline Video Gambling Regulation

We obtained information regarding the dial-up system from system manufacturers and from other states using automated systems. Compared to a stand-alone system, a dial-up system is designed to monitor a larger number of machines while requiring minimal employees, less paperwork, and eliminating a loss of revenue through intentional or non-intentional exclusion of information or other control problems. The overall objective of this system is to make the regulation process as effective and efficient as possible. Even though a dial-up system is designed to improve the regulation over video gambling, its use would also minimize disruptions the gambling establishments experience because of the stand-alone system. The following sections discuss how a dial-up system could streamline the regulating process for both GCD and the gambling industry.

Chapter VI

Long Term Solution

Monitoring is More Effective and Less Time Consuming

A dial-up system automatically provides full accountability of machine activity and revenues on a more frequent basis. There is no need to limit data gathering to quarterly or other cycles. The system allows the regulator to establish a schedule for gathering data. However, it still provides the regulator the capability of verifying machine activity at any time if the need arises. This capability allows the regulator to spot trends or problems as they occur rather than weeks or months later.

Efficient Machine Inspections

State law currently allows GCD to inspect video gambling machines at any time. However, a dial-up system can do this in a matter of a few seconds rather than sending field staff to manually do the inspection. Such a system automatically monitors machine operation and activity including checking the EPROM. The dial-up system would also make these inspections more cost efficient. More information can be obtained for the cost of a telephone call than is possible by physically visiting gambling establishments. These visits often require field staff to travel great distances to investigate a potential problem with only one machine. Additionally, play of the machines would not be disrupted while these automatic inspections occur. In contrast, physical inspections require removing video gambling machines from play.

Complete Reporting

The dial-up system eliminates division dependence on gambling establishments to provide information on machine activity and revenue. It also eliminates the risk of human error which can occur in providing this information. As discussed in Chapter IV, we found between 30 and 40 percent of gambling establishments provide insufficient documentation with video gambling tax returns. One of the primary sources of documentation required by statute and administrative rule is machine audit tickets. However, our review showed these tickets are often not submitted to the division or are illegible. This occurs with 25 to 32 percent of all gambling establishments.

We also found indications of possible machine malfunctions and human errors. Our review showed many tax returns contain incorrectly recorded meter readings. Between 31 and 41.5 percent of gambling establishments statewide have video

gambling machines with conflicting meter readings. The mechanical and electronic meters on the machines do not record the same amount of play and income.

Reduces Paperwork

Since a dial-up system automatically gathers play and revenue statistics, there would no longer be a need for gambling establishments to manually complete and submit quarterly tax returns and associated documents such as machine service reports and audit tickets. Some manual records, such as service logs stored in each machine, may still be necessary. The division would no longer need to perform the time-consuming task of physically reviewing these tax returns. Paperwork would be reduced. Efforts of staff currently performing these functions could be re-directed. The main responsibilities required of gambling establishments would be to ensure only authorized machines are used in their establishments, required records are maintained, and taxes paid.

**Thorough Control Over
Machine Operations**

Improperly operating machines can result in the incorrect amount of tax being paid and noncompliance with statutory operating requirements. Our review of quarterly tax returns noted a frequent amount of servicing to gambling machines. These services are generally for repair of operating malfunctions or machine upgrades. All service to video gambling machines is to be thoroughly documented. During our review we were often unable to determine why machine service was completed because documentation was missing or unreadable. We also noted the more often a machine is serviced, the higher the likelihood the "audit trail" is lost. A dial-up system would provide a better control system over machine operation including recording service which is performed on video gambling machines.

**Ensures Correct Tax is
Paid**

A dial-up system provides greater assurance the correct amount of tax is paid by gambling establishments because income and tax calculations are automated. As our report noted earlier, our review of video gambling machine tax returns found they are often inaccurate. An incorrect amount of tax may have been paid by as much as 60 percent of gambling establishments in this state. We found some establishments paid too little tax; others overpaid.

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There is the Option of Tax Revenue being Collected More Efficiently

A dial-up system can also improve the process of collecting tax revenues from video gambling activities. The dial-up system can calculate the amount of tax due for each gambling machine. Taxes could be collected using an electronic funds transfer (EFT) within days of the end of the billing cycle. The authorized transfer would be performed by the central computer system. EFTs would reduce the risk of delinquencies. Such transfers would also maximize the interest earned on gambling taxes, especially if taxes were collected on a more frequent basis. It would no longer be necessary for gambling establishments to submit a check for payment of taxes. An EFT system is one option offered with a dial-up system.

Currently, state law requires gambling establishments to submit gambling-related taxes on a quarterly basis. However, by using an EFT system to collect taxes, the billing cycle could be adjusted to increase the frequency of collections. We found other states with video gambling machines collect taxes more frequently than Montana. For example, South Dakota and Louisiana both collect video gambling machine taxes bi-weekly. Both states use automated monitoring systems and EFTs. They told us they have few problems with delinquent payment of taxes.

We calculated the amount of additional interest that could be earned by electronically collecting tax revenues via a dial-up system on a bi-weekly basis. Collecting revenues more frequently enables these revenues to be invested for a longer period of time. For fiscal years 1990-91 and 1991-92, we determined an additional \$210,000 in interest could have been earned by more timely revenue collection. This would provide additional revenue to the state General Fund. Any change in the frequency of tax collections will require amending the current law requiring quarterly payment of video gambling taxes.

**Dial-up System may
Improve Other Areas**

A dial-up system would help overall division operations be more efficient by re-directing staff efforts. For example, the number of applicants for gambling licenses has continued to increase due to new establishments opening and existing establishments being sold. Therefore, division revenue agents spend a great deal of their time doing licensing related reviews in order to get licensing completed in a timely manner. As a result, the division has not been able to conduct the amount of field audits necessary to ensure gambling establishments comply with state gambling regulations. Since a dial-up system continually monitors video gambling machine activity, the necessity of field audits would be reduced. This could provide more time for revenue agents to dedicate to licensing applicants and result in a faster licensing process. In fact, only one of the states we contacted which uses an automated system also conducts field audits of gambling establishments. All the other states told us they rely on information their automated monitoring system provides.

A dial-up system could also provide maintenance information to help monitor video gambling machines. A dial-up system quickly identifies machines experiencing operating malfunctions. This allows the division to intervene and ensure corrective action is taken. This information would be used to notify gambling establishments about malfunctioning machines. For instance, South Dakota has a procedure to notify vendors or establishments of malfunctioning machines. This procedure ensures the video gambling machine is repaired in a timely manner to reduce the down time of the machine. This minimizes lost revenues for both the state and the gambling establishment.

**Dial-up System Imple-
mentation Costs**

We reviewed the costs which could be incurred with implementing a dial-up system. Primary costs would be associated with purchasing central system hardware and software and modifying existing video gambling machines.

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Hardware and Software Costs

Computer hardware and software are the primary components of a central dial-up system. We contacted manufacturers of dial-up systems to discuss costs of hardware and software. They indicated there would be costs related to the original purchase of the hardware and software as well as on-going maintenance. Hardware and software maintenance costs exist with the purchase of any computer system.

We found there are a variety of vendors who manufacture dial-up systems. All these systems provide basically the same information. The variety of manufacturers affords alternatives to Montana in order to obtain the lowest possible cost. We contacted other video gambling states to determine what hardware and software costs were incurred with their dial-up systems. For example, South Dakota's hardware and software initially cost approximately \$1.52 million including the hardware and software maintenance contracts. However, South Dakota told us they recently replaced their original system and purchased a different brand of hardware which cost approximately \$460,000 less.

Utilizing Montana Lottery's Computer may be Feasible

The Montana Lottery utilizes a Stratus Computer system to perform various functions associated with the Lottery. We examined the possibility of using the Lottery's computer system as the central computer for a video gambling machine dial-up system. We discussed this issue with manufacturers of dial-up systems and Lottery officials.

We found it is feasible to use the Lottery's computer system as the central system. Dial-up manufacturers told us software is available which is compatible with the Lottery's computer system. Utilizing the Lottery's computer system as the central computer for a dial-up system would eliminate the necessity of a major hardware purchase. This would considerably reduce the costs associated with implementing a dial-up system.

Lottery officials said they would consider the idea of using the Lottery's computer for a dial-up system acceptable. They did not believe using their computer would be disruptive to Lottery operations. Lottery officials said it may be necessary to add

additional disk space and memory to handle the extra load of a dial-up system. However, these upgrades would still be less expensive than purchasing entirely new hardware.

Modification Costs

Some modification of video gambling machines will be required to be compatible with a dial-up system. These costs are necessary in order to modify video gambling machines so they can communicate with the central computer system. Modification costs are a direct result of not implementing video gambling and a dial-up system at the same time. Modification costs were not experienced by other states which have automated monitoring systems because the two were introduced concurrently.

A wide diversity of video gambling machines are currently operating in gambling establishments around Montana: old machines, new machines, and machines from a number of different manufacturers. Machines would require varying amounts of modification depending on the age and the machine's manufacturer. Although implementation of a dial-up system would require all video gambling machines in Montana be modified to some degree in order to communicate with a central computer system, the majority require only minor modification. Modifying the machines would be the major cost associated with implementing a dial-up system. The following describes the different types of modifications which would be required.

Minor Modifications - Machines falling under this category essentially have the ability to communicate with a central computer. Modifications would only include adding modems, ports, and/or cables. A modem and ports are needed to allow data transmission over existing or dedicated telephone lines.

Major Modifications - These machines do not currently have the ability of communicating with a central computer and would require major upgrades to do so. Modifications would most likely include upgrading or replacing machine circuitry. Additionally, these machines would also need to be equipped with modems, ports, and cables.

Not Feasible - It would not be feasible to modify these machines because only a few machines are in existence and/or

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the manufacturer has gone out of business. These machines are obsolete and parts are not easily replaced.

The division estimates at the present time approximately 61 percent (8,540 machines) of the video gambling machines would require minor modification while 38 percent (5,320 machines) would require major modifications. It would not be feasible to modify only 1 percent (140) of machines currently in operation.

It is difficult to determine the exact cost to complete necessary machine modifications. System manufacturers provided a "rough" cost estimate for modifying gambling machines. Costs could range from \$500 to \$1,000 per machine. Minor modifications would be the least expensive and major modifications would be the most expensive to make. As the number of video gambling machines operating in Montana continues to increase, the total cost for modifying the machines will also increase. However, new machines operating in the state are readily compatible with a dial-up system and; therefore, require only minor modifications. This reduces the average modification cost per machine.

Phasing-In System Could Alleviate Costs

We discussed implementation costs for a dial-up system with system manufacturers. We were told a phase-in period for implementing a dial-up system could reduce implementation costs. This would provide time to make necessary changes while minimizing the effects of these changes for both the division and the gambling industry. A phase-in period would require that various functions of a dial-up system be implemented at different points in time.

For example, a dial-up system provides three basic functions: 1) automatic collection of play statistics; 2) EPROM signature verification; and, 3) electronic fund transfer (EFT). One manufacturer we interviewed recommended the first phase of implementation should be the automatic collection of play statistics. These play statistics would provide the division the information necessary to verify video gambling machine revenues and corresponding taxes. This information would include areas such

as cash deposited into the machine, net income, number of credits played and won, machine servicing, power failures, and game play statistics such as, winning combinations and frequency of play. This information would help the division improve its monitoring process of video gambling machine activity and revenue by providing more accurate and timely information than is currently obtained. This manufacturer states only minor video gambling machine software modifications may be required before bringing the machines on-line to perform this function.

As the second part of a phase-in process, the gambling device manufacturer recommends implementing the EPROM signature verification function. This function requires more complex video gambling machine software modifications to communicate with a central computer system. The responsibility for modifying video gambling machine software would fall on the machine manufacturer. A phase-in period would allow for a gradual phasing-in and phasing-out of various machine models.

Finally, the EFT capability would be the final function to be implemented. The previous two functions relate directly to the regulation of video gambling machine activity and revenue. Although EFT sweeps would improve the timeliness and efficiency of tax collections, they are not necessary to improve the monitoring of video gambling machine activity. Therefore according to system manufactures, this function should have the last priority.

In summary, phasing-in a dial-up system would allow costs to be allocated over a period of time. It could also provide for better planning and communication between the division, gambling industry and the public. This would ensure a smoother transition from a stand-alone system to a dial-up system.

**Change in Administrative
Rule Would be Required**

Division officials told us new machines coming into the state are basically dial-up ready requiring only minor modification. However, administrative rules currently do not require video gambling machines operating in Montana to have the ability to communicate with a dial-up system. Division officials indicated video gambling machines are dial-up ready only because

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Montana is a secondary market for other states that have automated monitoring systems.

One of the first requirements in implementing a dial-up system would be an amendment to the administrative rules. This amendment would require all video gambling machines manufactured for use in Montana to have the ability to communicate with a central computer system. A dial-up system would only have limited success without making this change. First, not having this requirement could increase the risk of unauthorized machines operating in the state. Secondly, the division would have little or no recourse in preventing machines from operating that do not communicate with a dial-up system. Such a change could be phased-in to require all machines to be dial-up ready over a period of time. This would greatly reduce total modification costs. The division currently has statutory authority to make this administrative rule change.

Conclusion

The stand-alone system Montana currently uses is a manual and labor intensive monitoring system. It is not capable of effectively nor efficiently monitoring over 14,500 machines in a state as large as Montana. This is evident by the number of problems we noted with tax returns and video gambling machines during our audit. These problems included: inaccurate tax returns; missing tax return documentation; mechanical and electrical meters not balancing; incomplete tax returns; resetting of meters; and, math errors by establishments and vendors when determining the amount of tax due. We also found video gambling machines operating in the gambling establishments are not always operating according to state specifications. It is just not feasible for division staff to physically inspect all the gambling machines in the state to ensure proper operation.

Provides Effective Monitoring with Minimal Employees

The more effective and efficient system for monitoring video gambling activities and revenues would be an automated system. A dial-up system would provide an effective monitoring system with minimal employees. This would also improve the integrity of video gambling by ensuring the public and gambling industry

is protected and by enhancing the accountability of public funds. Such a system would be more effective in identifying problems.

It is important to note that a dial-up system monitors the same activities as Montana's current manual system is intended to do. The difference is the dial-up system monitors these activities more thoroughly, efficiently and effectively.

**Better Ensures Fair and
Legal Activities**

If the current system had increased staffing and improved controls in place, it would be a more effective system and could accomplish things similar to a dial-up system. However, the lack of controls prevent the current system from meeting statutory intent. Automating would provide a system which better meets the intent of Montana's public policy law regarding gambling activities. This is accomplished by providing a level of monitoring which ensures the public, state and gambling industry are protected from unfair and illegal activities.

**Present Plan to Next
Legislative Session**

The manual monitoring system currently utilized by the department is the cause of most of the problems we found during our review. Therefore, the Department of Justice should implement an automated system. The department should determine what type of data a dial-up system should provide, the most efficient means of operating the system, and how system implementation costs should be recovered. The department will also need to determine how job duties and staffing levels of division employees would be affected. It appears the automated system would not entail an increase in staffing, but instead a change of duties and subsequent training. In addition, the department should determine the time-line for dial-up system implementation. Since implementation of such a system will take time, the department should present its plan to the next regular legislative session.

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Recommendation #6

We recommend the Department of Justice present a plan to the 1995 Legislature to implement a dial-up system to monitor video gambling activities and revenue.

Agency Response

ATTORNEY GENERAL
STATE OF MONTANA

DEC 30 1993

Joseph P. Mazurek
Attorney General



Department of Justice
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December 30, 1993

Lisa Blanford
Senior Performance Auditor
Office of the Legislative Auditor
State Capitol
Helena, MT 59620

Dear Lisa:

Thank you for the opportunity to respond to the final report on the audit of the regulation of video gambling machines. I have divided the department's response into two categories: (1) general comments; and (2) specific responses to audit recommendations.

General Comments

The Department of Justice concurs with the audit staff's determination that the primary focus of the report should be the process for collecting and verifying tax revenues, and applauds the fact that sufficient time was allocated for your staff to conduct field audits. Tax revenue is a critical aspect of the state's regulation of video gambling machines and of great importance to both state and local government revenues.

As a relatively new agency, the Gambling Control Division (GCD) is just now completing the first significant evaluation and rewriting of the division's administrative rules. In addition, the 1993 Legislature mandated that the division complete an efficiency study by June 1994. Consequently, the content and recommendations in the performance report will help the division improve existing policy and procedures, and provide guidance on the need for additional rule and/or statutory changes.

In general, the department agrees with the audit findings and recommendations. The department agrees that:

- ▶ The issues you identified should be addressed;
- ▶ New policies should be implemented and existing ones reinforced; and
- ▶ Additional monitoring or informational systems should be developed and implemented.

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As stated in the report's recommendations, more field audits and more inspections of video gambling machines are necessary to ensure a higher level of reliability with the tax reporting system. We also agree with the report's basic conclusion: increased reliability can only be accomplished by adding audit and testing staff (23 additional full-time employees) or by implementing a long-term solution involving an automated monitoring system.

The focus of your report--tax collection and machine inspections--covers only two of the critical tasks assigned to the Gambling Control Division. Given the frequent turnover in the ownership of gambling operations (approximately one-quarter of all gambling operators each year), the GCD's time and resources are currently concentrated on processing license applications. While GCD resources are devoted to streamlining the application process, system enhancements and enforcement activities have been delayed.

Tremendous growth in the number of machines and in the amount of tax collections have resulted in substantially more reporting activity. Despite this growth, only two staff positions directly related to machine inspection or auditing (a gambling machine testing inspector and a revenue agent) have been added since the GCD's inception.

Given the volume of data that must be processed, the manual systems currently used to process inspections and audits are inherently inefficient. Any improvements the division can make in these systems with current resources may still prove to be insufficient to keep up with the present and projected workload. Realistically, given the substantial number of machine and record keeping violations by current owner/operators identified by the audit report, it would be difficult for the GCD to keep up with the field audits, the resulting penalties, and the protested penalties that would result from better identification of machine problems and improper tax payments. As pointed out in the audit, existing staffing levels limit the amount of review that can be accomplished.

Specific Audit Recommendations

Recommendation No. 1A, Establish a centralized management information system for machine inspection data:

The GCD has implemented and is currently operating a database for this information. Since the addition of the gambling machine inspector, primary responsibility for routine inspections has been moved from the Investigations Bureau to the Technical Services Section. As a result, the division has increased the number of inspections completed by 400 percent. This is possible because the individual assigned to this task does not have any additional responsibilities. This change has provided the GCD with substantially more information on machine inspection results than has been available in the past.

Recommendation No. 1B, Distribute inspection-related management information to Division staff:

The next step in the development of the inspection data base will be integration of management information with other systems. However, staff time is necessary to develop and install management information system programs. Current enhancement efforts, daily system support to approximately 40 users, and new machine approvals have priority over new program development. Limited staff time is available to accomplish these goals.

Recommendation No. 1C, Use this system to provide a means of scheduling machine inspections:

Since machine inspections are being done only once every seven years, the GCD is still scheduling inspections of machines that have not yet been inspected. Once all existing machines have been field tested, improvements to our management information systems could improve future scheduling. However, the data is based on individual machines, not machine locations. Location is important because machines are frequently moved from place to place. This is especially true of vendor-owned machines, which make up approximately 70 percent of all machines in the state. As a result, targeting a location on the basis of past problems may not be effective since the machines may have been moved to another location.

Recommendation No. 2A, Establish a policy that requires EPROM testing be a standard part of machine inspections, and

Recommendation No. 2B, Develop procedures for conducting video gambling machine inspections including EPROM testing:

Since fall 1992, the GCD's policy for machine inspections has included the proper procedures for machine inspections, including EPROM testing. The routine testing described in the policy is now the responsibility of the Technical Services section, and is also available to the Investigation Bureau.

Recommendation No. 3, Increase use of penalties and other statutory sanctions to ensure improved industry compliance with record keeping and record retention provisions:

The GCD implemented record keeping penalties in 1991. We are not sure whether this has been effective in encouraging increased vigilance on the part of the industry. Penalties have not been well received by industry members. Nevertheless, the penalties are currently the Division's only tool to gain compliance. As suggested in the audit report, the Division will consider using stronger measures against machine owners who continue to be in noncompliance.

Recommendation No. 4, Implement a system to document compliance problems and division enforcement status:

The GCD agrees with this recommendation and plans to develop such a system when existing on-line systems have been upgraded and staff time is available.

Recommendation No. 5, Expand the machine service report database to identify compliance problems and to select operators and vendors for detailed compliance reviews:

The GCD agrees with this recommendation and will develop system enhancements when staff time is available.

Recommendation No. 6, Present a plan to the 1995 Legislature to implement a dial-up system:

During the 1993 Legislative Session, the Department did not take a position on a dial-up system. Implementation of such a system would significantly affect the GCD's operations and the gaming industry. In view of the Legislative Auditor's recommendations, however, the GCD will consider the feasibility of implementing a dial-up system.

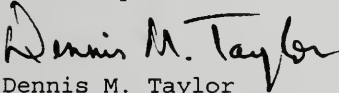
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Considerable work will be necessary to develop a viable plan that will address the substantial concerns gambling operators have with a dial-up system, as well as the impact on the GCD. For example, the audit report does not suggest funding sources for the considerable costs required to implement such a system. Nor does it take into account the financial impact on machine owners. Additional issues that need to be addressed include the timing of implementation and the type of system to be used (i.e., development of the state's own system following the Australian example, or purchase of a "packaged" system from the private sector, as is done in South Dakota).

If these issues cannot be addressed by the GCD using existing resources, the Division may ask the Gambling Advisory Council and the Attorney General to request funding from the 1995 Legislature for a comprehensive feasibility study.

I hope we will be able to continue to consult with you and your staff on an ongoing basis as the Gambling Control Division moves forward to address the issues and recommendations contained in this performance audit report.

Sincerely,



Dennis M. Taylor
Deputy Director

dmt/cpg

Hand-Delivered

c: Attorney General Joseph P. Mazurek
Janet Jessup
JanDee May

